IN THE

Supreme Court of the United States

OCTOBER TERM, 1976

No. 77-119

SOPHIE RUSKAY, LOUIS FELDMAN, Trustee etc., WEBSTER FACTORS, INC., and IRWIN L. FEINBERG, as Trustee etc.,

Petitioners,

—versus—

CHAUNCEY L. WADDELL, JOE JACK MERRIMAN, CORNELIUS ROACH, MITCHEL J. VALICENTI, WADDELL & REED, INC. (a New York corporation), WADDELL & REED, INC. (a Massachusetts corporation), and UNITED FUNDS, INC.,

Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

WILLIAM E. HAUDEK
Attorney for Petitioners
295 Madison Avenue
New York, N.Y. 10017
(Tel.: 212—532-4800)

POMERANTZ LEVY HAUDEK & BLOCK
Of Counsel

July 21, 1977

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Sophie Ruskay, Louis Feldman, Trustee etc., Webster Factors, Inc., and Irwin L. Feinberg, as Trustee etc.,

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—versus—

Chauncey L. Waddell, Joe Jack Merriman, Cornelius Roach, Mitchel J. Valicenti, Waddell & Reed, Inc. (a New York corporation), Waddell & Reed, Inc. (a Massachusetts corporation), and United Funds, Inc.,

Respondents.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

Petitioners, who were the plaintiffs-appellants below, pray this Court for a writ of certiorari to review the judgment of the Second Circuit entered February 17, 1977.

Opinions Below

The opinions of the Second Circuit (1a*) and of the District Court for Southern New York (26a) are reported,

* Numerals followed by the letter "a" (e.g., "1a") refer to pages of the Appendices of this Petition. Numerals preceded by the letter "A" (e.g., "A15") refer to the Appendix in the Court below.

respectively, at 552 F. 2d 392 (1977) and 342 F. Supp. 264 (1972).

Jurisdiction

The judgment of the Second Circuit (22a) was dated and entered February 17, 1977. A timely petition for rehearing was denied May 9, 1977 (25a). The jurisdiction of this Court is invoked under 28 USC § 1254(1).

The jurisdiction of the District Court rested on § 44 of the Investment Company Act, 15 USC § 80a-43, and the principles of pendent jurisdiction.

Question Presented

Can a judicially approved settlement of a stockholders' derivative action validly authorize a general release of claims which have not been pleaded in the complaint, have never been considered or scrutinized by the Court, and whose existence and proposed extinguishment have never been made known to the stockholders?

The Court below, one judge dissenting, sustained the validity of such a general release. We submit that the decision is contrary to Rule 23.1 FRCP, to constitutional due process, and to the decisions of this Court as well as the Third and Fifth Circuits. The consequences of the decision for future settlements of derivative actions would be far-reaching and unfortunate indeed.

Constitutional and Statutory Provisions Involved

The Fifth Amendment of the Constitution provides that—

> "No person shall be * * * deprived of life, liberty or property, without due process of law; * * *."

Rule 23.1 of the Federal Rules of Civil Procedure provides that a shareholder's derivative action—

> "shall not be dismissed or compromised without the approval of the court, and notice of the proposed dismissal or compromise shall be given to shareholders or members in such manner as the court directs."

Summary of Argument

1. Before approving the settlement of a stockholder's derivative action, the district court must evaluate the strength of the claims to be discharged and balance them against the benefits of the settlement. *Protective Committee* v. *Anderson,* 390 U.S. 414, 434, 439-41 (1968); *City of Detroit* v. *Grinnell Corp.,* 495 F. 2d 448, 455 (2d Cir. 1974). In so doing, the court acts as guardian of the absent shareholders, in whose interest the action is brought, *Norman* v. *McKee,* 431 F. 2d 769, 774 (9th Cir. 1970). But the court cannot evaluate the unknown and unpleaded claims that are discharged by a general release; it is unable, therefore, to protect the absent parties' interests in such claims. By sanctioning such a general release, the decision below contravenes Rule 23.1 FRCP and is in conflict with *Girsh* v. *Jepson,* 521 F. 2d 153, 159 (3rd Cir.

1975).* It is also in conflict with due process, since it cannot be due process for a court to issue a blanket adjudication of claims without knowledge or consideration of their existence, let alone their nature, amount or probable merit.

2. The primary responsibility for negotiating a derivative settlement rests on the plaintiff who, under Rule 23.1, must "fairly and adequately represent the interests of the shareholders". Adequate representation is, moreover, required by constitutional due process. *Hansberry* v. *Lee,* 311 U.S. 32 (1942); *Gonzales* v. *Cassidy,* 474 F. 2d 67, 74 (5th Cir. 1973); *Papilsky* v. *Berndt,* 466 F. 2d 251, 259-60 (2d Cir.), *cert. denied,* 409 U.S. 1077 (1972). To be adequate, the representation must insure the forthright, vigorous and tenacious prosecution of the claim; *Gonzales, supra,* at 75; *Papilsky, supra,* at 259-60. But a derivative plaintiff cannot adequately represent the shareholders with respect to claims he has not pleaded, whether due to ignorance of their existence or lack of faith in their merit; he does not "insure the vigorous prosecution" of such claims. A general release of unpleaded claims as part of a derivative settlement is thus incompatible with the constitutional and statutory requirement of adequate representation. The decision below, nevertheless, gives effect to such a general release.

3. A general release is also incompatible with the requirement of an adequate settlement notice to the stockholders. The notice is prescribed by Rule 23.1 and is required by constitutional due process, *Eisen* v. *Carlisle & Jacquelin,* 417 U.S. 156, 173 (1974); *Greenfield* v. *Villager Industries,* 483 F. 2d 824, 831, 833-34 (3d Cir. 1973). Notice is essential "to ensure that the dismissal of the derivative suit is in the best interests of the corporation and the absent stockholders"; it enables the stockholders "to intervene to protect the corporate claim and to continue the litigation if that seems advisable"; *Papilsky, supra,* 466 F. 2d at 258. Hence it is that only "maximum notice" "can comport with constitutional standards of due process", *Girsh* v. *Jepson, supra,* 521 F. 2d at 159 and n. 12. But a notice that unpleaded and unknown claims are to be extinguished by a general release leaves the stockholders in the dark and prevents them from protecting their corporation's claims precisely because those claims are unknown; the notice thus fails to fulfill its purpose. Such was the notice at bar. Since an inadequate notice is inconsistent with due process, it deprives the judgment of res judicata effect, *Smith* v. *Alleghany Corp.,* 394 F. 2d 381, 391 (2d Cir.), *cert. denied,* 393 U.S. 939 (1968), and invalidates a general release given pursuant to the settlement.

4. If the decision below is permitted to stand, the use of general releases in derivative settlements will become universal. Corporate wrongdoers will be able to secure blanket absolution for undisclosed fiduciary breaches by paying a relative peppercorn for a general release. In the present case, the settlement of a $2,000,000 claim (46a) for $650,000 has been held to wipe out a $62 million liability through the device of a general release (13a). Such a result may be tolerable in a release executed by a private party on his own behalf (as in the cases cited by the Court

* The *Girsh* case forbids judicial approval of the release of an unpleaded claim without development of its probable merit and of the fairness of the consideration for surrendering the claim.

below at 8a-9a*), but not in derivative or class settlements. A general release in such actions would destroy crucial safeguards of valuable corporate and class rights, would defeat due process and the purpose of Rule 23.1, and would open the door to countless abuses. The courts, appointed to act as guardians of the rights of absent shareholders, would become the vehicles for the destruction of such rights.

Statement of the Case

Petitioners are stockholders of defendant United Funds, Inc. ("United"), a registered mutual fund. They brought these four derivative actions, consolidated by the District Court, against the directors of United, against Waddell & Reed, Inc. ("W&R"), United's investment adviser and principal underwriter, and against the principal stockholders of W&R. In 1969 the W&R stockholders, including three of the individual defendants, sold the stock of W&R to a new owner, Continental Investment Corporation. The price, $80 million, was vastly in excess of W&R's asset value of $18 million. Under the Investment Company Act (the "Act"), 15 USC § 80a-15(a)(4) and 15(b)(2), the sale automatically terminated United's advisory and underwriting agreements with W&R (the "service agreements"). Since these agreements were the principal source of W&R's income, the parties to the sale conditioned their contract upon the reinstatement of the service agreements by the

* The only case cited below that concerned the effect of a release pursuant to a derivative or class settlement is *Stella* v. *Kaiser*, 218 F. 2d 64 (2d Cir. 1954), *aff'd on rehearing*, 221 F. 2d 115 (2d Cir.), *cert. denied*, 350 U.S. 835 (1955); but the claim there held to be discharged had been alleged in the earlier action and was specifically involved in the earlier derivative settlement.

stockholders and directors of the Fund. The sellers and the management of the Fund agreed to procure the reinstatement of the agreements; they did procure it, and the $80 million was paid (A1-A16).

Petitioners charge that the transaction violated the Act because it constituted a sale of W&R's fiduciary offices as adviser and underwriter. Petitioners seek to recover the $62 million excess of the sales price over the asset value of the stock under the principles of *Rosenfeld* v. *Black*, 445 F. 2d 1337 (2d Cir. 1971), *cert. dismissed*, 409 U.S. 802 (1972). Since the rationale of *Rosenfeld* is relevant here, we summarize it in the margin.*

The District Court granted summary judgment dismissing this claim (26a) as barred by a judgment and release issued in connection with the settlement of two earlier derivative actions brought by stockholders of United (the "Horenstein-Ruskay actions"). Commenced in 1967 and early 1969 (long before the W&R stock sale), these actions charged that a subsidiary of W&R, acting as stock broker for United, had engaged in improper brokerage practices yielding large illegal profits to W&R and its subsidiary at the expense of United (3a). When the proposed sale of W&R's stock was announced in 1969, the Horenstein-Ruskay plaintiffs secured leave to and did file

* *Rosenfeld* rests on the familiar principle that a fiduciary may not sell his office for personal gain (445 F. 2d at 1342). An investment adviser is a fiduciary under the Act (pp. 1342-43). While he cannot directly assign his office to another (p. 1344), he can bring about a transfer of the office by inducing the stockholders of the fund to appoint his chosen successor (*ibid.*). It is this use of influence with the stockholders of the fund for which the adviser, as a fiduciary, must not accept personal gain (pp. 1342, 1347 n.13). He does accept such gain if the price he receives exceeds the asset value of the advisory company.

supplemental complaints alleging that part of the sales price was an outgrowth and, in effect, a capitalization of W&R's illegal brokerage profits and should, therefore, be impressed with a trust for the Fund (30a; A107, A172). The Horenstein-Ruskay supplemental complaints did not, however, charge that the 1969 transaction was a sale of W&R's advisory and underwriting offices, nor did they allege the facts necessary to support such a charge.* Indeed, the District Court held that Horenstein-Ruskay "consciously avoided" such a claim (32a).

Ultimately, in 1970, the Horenstein-Ruskay actions were settled with court approval pursuant to FRCP 23.1. In submitting the proposed settlement, Horenstein-Ruskay advised the District Court that their supplemental complaints—the only complaints containing any reference to the W&R stock sale—had "become moot" and were "not a factor to be considered by the Court" (41a). Neither the settlement notice to the stockholders of the Fund (35a) nor Judge Lasker's decision approving the settlement (42a) suggested that a claim for the sale of the advisory and underwriting offices was alleged or was to be included in the settlement. The judgment (A228) and the general release (5a; A234) issued by United pursuant to this settlement were the basis on which the District Court dismissed the present actions (26a). The Court of

* A dictum of the Court below suggests otherwise (10a-11a); but the Horenstein-Ruskay supplemental complaints (11a, n.12; A107, A172) did not allege that the $80 million sales price for the W&R stock included a substantial premium in excess of the asset value of the stock; or that, in return for the premium, the sellers and W&R agreed to and did arrange for the reinstatement of the service agreements; or that the stockholders and directors of United did approve such reinstatement. These are essential elements of a claim under *Rosenfeld;* see p. 7 n., above.

Appeals affirmed solely on the basis of the general release, but did not pass on the issue of res judicata (13a).

Reasons for Granting the Writ

For present purposes we accept, arguendo, the holding below that the language of the general release (5a; A234) was sufficiently broad to include the present sale-of-office claim.* That claim, however, was not alleged in Horenstein-Ruskay; its existence was not revealed in the settlement notice to United's stockholders; Judge Lasker's settlement decision did not mention the claim, let alone scrutinize its possible merit. We submit that the discharge of the claim by a sweeping general release was invalid.

1. *The general release in Horenstein-Ruskay did not extinguish the sale-of-office claim because Judge Lasker's settlement decision gave no consideration to that claim.*

When Horenstein-Ruskay submitted their settlement to the Court, they advised Judge Lasker, as noted, that their supplemental complaints—the only complaints referring to the W&R stock sale—had "become moot" and were "not a factor to be considered by the Court" (41a). Judge Lasker's settlement decision (42a) did, indeed, not so much as mention the stock sale, let alone consider a sale-of-office claim. In summarizing and carefully analyzing the plaintiffs' charges, he discussed solely the alleged brokerage abuses (44a-46a). Since the amount of the brokerage claim was about $2,000,000, Judge Lasker concluded that the settlement, ranging from $535,000 to $650,000, was

* For a contrary view of the scope of the release, see the dissenting opinion below (13a).

"respectable" (46a). It is hard to conceive that this decision could validly authorize the unwitting release of an unknown $62 million sale-of-office claim.

As noted, a court cannot approve a derivative settlement without scrutinizing the strength of the claims and balancing them against the benefits of the settlement. *Protective Committee* v. *Anderson, supra,* 390 U.S. at 434, 439-41; *City of Detroit* v. *Grinnell Corp., supra,* 495 F. 2d at 455. If an unpleaded claim is to be released, it must be subjected to the same scrutiny and evaluation, *Girsh* v. *Jepson, supra,* 521 F. 2d at 159. The Horenstein-Ruskay settlement decision, far from evaluating the sale-of-office claim, did not even mention it. To treat this decision as authorizing the extinction of the claim would give it an effect incompatible with either due process or Rule 23.1.

The Court below refused to consider the propriety of the general release because "one who has obtained the benefit of a settlement [should not be allowed] to object, in a subsequent proceeding, that the documents he helped draft were unfair to him" (6a, n.4). This language referred to Sophie Ruskay, who is one of the plaintiffs in this case and was a plaintiff in Horenstein-Ruskay. The Court below overlooked, however, that the three other petitioner-plaintiffs in the case at bar—Louis Feldman, Webster Factors, Inc. and Irwin I. Feinberg—had nothing to do with the Horenstein-Ruskay litigation and certainly did not "help draft" the general release. The same error underlies the remark of the Court below about "plaintiff" having given a general release (10a); the three plaintiffs other than Sophie Ruskay did nothing of the sort. Plaintiffs' appeal brief below (p. 38 n.) expressly referred

to the difference between Ruskay and the three other present plaintiffs.*

2. *The general release in Horenstein-Ruskay did not extinguish the sale-of-office claim because the plaintiffs could not adequately represent the stockholders with respect to that claim.*

As noted, the requirement that a derivative plaintiff be an adequate representative of the stockholders is rooted not only in Rule 23.1 but in constitutional due process; *Hansberry* v. *Lee, supra,* 311 U.S. 32; *Gonzales* v. *Cassidy, supra,* 474 F. 2d at 74; *Papilsky* v. *Berndt, supra,* 466 F. 2d at 259-60. Adequate representation must be such "as to insure the vigorous prosecution of the claim", *Papilsky, ibid.* The Horenstein-Ruskay plaintiffs certainly did not vigorously prosecute the sale-of-office claim. They did not even plead the claim; their settlement brief expressly disavowed the supplemental complaints (41a), the only complaints mentioning the W&R stock sale. Since Horenstein-Ruskay thus did not adequately represent United's stockholders with respect to the sale-of-office claim, they were powerless to give the claim away by the device of a general release.

A settlement decree in a derivative suit is res judicata only "where the notice [to stockholders] and representation are adequate"; *Smith* v. *Alleghany Corp.,* 394 F. 2d

* Equally erroneous is the assumption of the Court below that counsel for Horenstein-Ruskay were familiar with the sale-of-office theory because they were, at the same time, contesting the District Court decision in *Rosenfeld* v. *Black* (10a). The firm of Pomerantz Levy Haudek & Block, who prosecuted *Rosenfeld* v. *Black* and who are general counsel for the present plaintiffs, had nothing to do with the Horenstein-Ruskay litigation (plaintiffs' appeal brief, p. 16 n. 2; see list of Horenstein-Ruskay counsel, 42a).

381, 391 (2d Cir.), *cert. denied* sub nom. *Smith* v. *Kirby*, 393 U.S. 939 (1968); 7A *C. Wright and A. Miller, Fed. Prac. & Proced.*, Civil (1972), § 1840, p. 440. Since an inadequate representative cannot bind his fellow stockholders by res judicata, *Phillips* v. *Tobin*, 548 F. 2d 408, 410 n. 2 (2d Cir. 1976), he cannot escape the constitutional requirement of adequate representation by adding a release to his settlement.

3. *The general release in Horenstein-Ruskay did not extinguish the sale-of-office claim because the settlement notice did not advise the stockholders that such a claim was to be released.*

The Horenstein-Ruskay settlement notice (35a) described the proposed release as discharging defendants from liability with reference to any "matters or transactions described or referred to in the various pleadings by the plaintiffs" (38a). The scope of the release was thus to be determined by the contents of the plaintiffs' pleadings. In describing those pleadings, the notice set forth the alleged brokerage abuses in considerable detail (35a-36a); but the supplemental complaints were simply described as alleging—

> "that the defendants Waddell, Merriman and Roach arranged to sell a majority of the voting shares of W&R held by themselves and members of their families at a price of $80 per share; that such price was largely attributable to the profits derived by W&R from the acts, transactions and practices complained of in their principal complaints; and that the proposed sale should be enjoined or the proceeds thereof sequestered for the benefit of United" (37a).

This was followed by a summary of the defenses to the supplemental complaints (37a).*

The notice thus did not reveal that the stock sale would transfer control of W&R; the sale was described as involving only a majority of the voting shares held by the named individuals and their families (not a majority of all outstanding voting shares). Nor did the notice reveal that the total sales price was $80 million; or that it substantially exceeded the asset value of the stock; or that the sale would terminate the service agreements; or that the sellers and W&R were to be paid for arranging the reinstatement of the service agreements; or that the agreements were, in fact, reinstated.

By no stretch of imagination could a reader of this notice have guessed that the settlement and release were to include a $62 million sale-of-office claim, i.e., a claim that the defendants, for private gain, had used their fiduciary influence with the stockholders and directors of United for the reinstatement of the service agreements. Stockholders, reading the notice, had no reason to suspect that such a claim, unrevealed by the notice and far exceeding in importance the claims disclosed, was to fall by the wayside. A settlement notice is designed to inform the stockholders not to become a trap for the unwary. The Horenstein-Ruskay notice was inadequate to warn the stockholders of the effects of the proposed general release.

As noted, an adequate settlement notice is required not only by Rule 23.1 but by due process, *Eisen* v. *Carlisle & Jacquelin, supra,* 417 U.S. at 173; *Greenfield* v. *Villager*

* Since the scope of the release was to be determined by the contents of the plaintiffs' pleadings, the recital of the defenses in the notice is, for present purposes, not relevant.

Industries, supra, 483 F. 2d at 831, 833-34; *Grunin* v. *International House of Pancakes,* 513 F. 2d 114, 120 (8th Cir.), *cert. denied,* 423 U.S. 864 (1975); *Milstein* v. *Werner,* 57 F.R.D. 515, 518 (S.D.N.Y. 1972). Just as a settlement decree based on an inadequate notice is not res judicata, *Smith* v. *Alleghany Corp., supra,* 394 F. 2d at 391, it cannot validly authorize a general release.

It is no answer, as suggested by the Court below (6a, n.4), that any objection to the grant of a general release should have been made in the settlement hearing before Judge Lasker. The stockholders of United could not object, precisely because the settlement notice did not give them the necessary information. In any event, the infirmity of the general release is of constitutional dimensions, because of the inadequacy of both the representation and the notice. The ineffectiveness of such a release—just as the ineffectiveness of an unconstitutional settlement decree as res judicata—can be raised collaterally and does not depend on the happenstance of stockholders' objections.

4. ***The importance of the question presented to the judicial administration of stockholders' derivative and class actions, as well as the conflict of the decision below with earlier decisions of this Court and other Circuits urgently call for the grant of review by this Court.***

Stockholders' derivative and class suits, this Court has held, "involve corporate therapeutics, and furnish a benefit to all shareholders by providing an important means of enforcement" of the securities laws; *Mills* v. *Electric Auto-Lite Co.,* 396 U.S. 375, 396 (1970).

The admission of general releases as part of derivative settlements would pervert the stockholder's action from a tool of corporate therapeutics into an engine of corporate inequity. No matter how meritorious and important a corporate claim might be, a general release embedded in a derivative settlement would wipe it out—and would wipe it out without the "benefit to all shareholders" which is the great and animating purpose of all stockholders' suits. Since a general release destroys even unknown corporate claims (10a, n.10), it operates without judicial scrutiny; it operates without the vigorous protection of the corporate claim by an adequate representative; and it operates without an opportunity for other stockholders to champion the claim. Such a destruction of corporate claims through the machinery of a stockholder's action mocks the purpose of derivative suits, which are designed to protect corporate causes of action, not to defeat them.

Corporate insiders and other defendants in derivative litigations have no justifiable interest in securing a general release. It is they who have intimate knowledge of their dealings with the corporation; the court, the stockholders at large and, in most instances, the derivative plaintiff lack that knowledge. If the defendants wish absolution from a claim not specifically asserted in the complaint, they are best able to supply the pertinent information; the plaintiff, the absent stockholders and the court will then be apprized, and the court can properly determine whether a release of the new claim should fairly be permitted. But a general release would allow the defendants to sneak into forgiveness.

A great number, probably a majority of meritorious derivative actions are disposed of by court-approved settle-

ments. Even now, general releases in derivative settlements are "not uncommon" (6a, n.4), although the decision below is the first to give them sweeping effect beyond the scope of res judicata. If that decision were to stand, it takes no great power of prophecy to foresee that the use of general releases in derivative settlements will become universal. Corporate insiders will, in this fashion, secure broad immunity for misconduct no matter how grave. This Court, we submit, should set its face against such erosion of constitutional due process, procedural fairness and elementary justice.

CONCLUSION

The petition for a writ of certiorari should be granted and the judgment below should be reversed.

Dated: July 21, 1977

Respectfully submitted,

William E. Haudek
Attorney for Petitioners
295 Madison Avenue
New York, N.Y. 10017
(Tel.: 212—532-4800)

Pomerantz Levy Haudek & Block
Of Counsel

APPENDICES

APPENDIX A

Opinion of the Court of Appeals

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

No. 213—September Term, 1976.

(Argued November 24, 1976 Decided February 17, 1977.)

Docket No. 76-7270

SOPHIE RUSKAY, LOUIS FELDMAN, Trustee, etc., WEBSTER FACTORS, INC., and IRWIN L. FEINBERG, as Trustee, etc.,

Plaintiffs-Appellants,

v.

CHAUNCEY L. WADDELL, JOE JACK MERRIMAN, CORNELIUS ROACH, MITCHEL J. VALICENTI, WADDELL & REED, INC. (a New York corporation), WADDELL & REED INC. (a Massachusetts corporation), and UNITED FUNDS, INC.,

Defendants-Appellees.

Before:

MANSFIELD, VAN GRAAFEILAND and MESKILL,
Circuit Judges.

Plaintiffs brought an action in the United States District Court for the Southern District of New York alleging a sale of fiduciary office arising out of a transfer of the stock of the investment adviser to a mutual fund. The district court, Metzner, *J.*, granted defendants' motion for

summary judgment on grounds of release and *res judicata*, and plaintiffs appealed.

Affirmed.

ABRAHAM L. POMERANTZ, New York, New York (Pomerantz Levy Haudek & Block, William E. Haudek, New York, New York, of counsel), *for Plaintiffs-Appellants.*

ALBERT D. JORDAN, New York, New York (Cole & Deitz, Martin S. Berglas, Robert M. Kerrigan, New York, New York, of counsel), *for Defendants-Appellees Merriman, Roach, Valicenti and Waddell & Reed, Inc.*

MARVIN SCHWARTZ, New York, New York (Sullivan & Cromwell, Susan J. McCone, New York, New York, of counsel), *for Defendant-Appellee Chauncey L. Waddell.*

KELLEY DRYE & WARREN, New York, New York (On the Brief), *for Defendant-Appellee United Funds, Inc.*

MESKILL, *Circuit Judge:*

This case arises out of the sale of the stock of an investment advisory company, a class of transaction that has spawned more than its share of unusually complex litigation. The instant appeal, the latest chapter in a series of class and stockholder actions concerning a large mutual fund, is no exception.

The mutual fund in question is United Funds, Inc. ("United"). Prior to 1969, the investment advisor of United was Waddell & Reed, Inc. ("W&R"). In that year, W&R sold 97 percent of its outstanding shares to Continental Investment Corporation ("CIC"). CIC then

merged W&R into one of its wholly-owned subsidiaries, CWR Corporation, whose name was changed to Waddell & Reed ("New W&R").

The investment advisory contract was terminated by operation of law when the sale was made. 15 U.S.C. §80a-15(a)(4). The sale was thus made conditional upon the reinstatement, by United's shareholders, of the contract with New W&R. In June, 1969, this approval was duly given.

Prior to this reorganization, two shareholder actions (the "Horenstein-Ruskay actions") were begun in federal court, one brought by Mrs. Ruskay, who is the plaintiff in the instant action as well.[1] In substance, these actions alleged that W&R had illegally diverted the brokerage business of United to a wholly-owned subsidiary of W&R, Kansas City Securities Corporation ("KCSC"). They also alleged that United's account had been "churned" and that W&R had appropriated "give-ups"[2] which properly belonged to United. The return of all these profits, allegedly amounting to several million dollars, was demanded. While this action was pending, the sale to CIC was announced. With that development, the theory of the action was changed by amending the complaint to allege that the price paid by CIC for W&R stock represented, in part, the profits realized from the breaches of fiduciary obligations set forth in the original complaints. The actions now sought

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1 In addition to the two actions involved in the instant appeal, Mrs. Ruskay has brought a derivative suit concerning United in New York Supreme Court, *Ruskay* v. *Reed*, Index No. 8283/64.

2 "Churning" occurs when an account is actively traded solely to generate commissions. The "give-ups" in this case arose when W&R ordered that the broker-dealers executing trades for United "give up" part of their commissions to other broker-dealers, who had not actually executed the trades in question, but had performed useful services for W&R and United. For an excellent discussion by Judge Friendly of the problems posed by give ups, *see Arthur Lipper Corp.* v. *SEC*, slip op. 901, 904-07 (2d Cir. Dec. 10, 1976).

recovery from W&R on a theory of constructive trust. In December, 1969, both of these actions were settled for $650,000. A release was executed in October, 1970.

The law governing the sale of an investment advisor's stock at that time was expressed in *Rosenfeld* v. *Black,* 319 F.Supp. 891 (S.D.N.Y. 1970). In that case, it was held that the sale of such stock for whatever the market would pay, absent any specific wrongdoing by the advisor, was entirely proper, and did not render the selling stockholder accountable to the fund. *See also SEC* v. *Insurance Securities,* 254 F.2d 642 (9th Cir.), *cert. denied,* 358 U.S. 823 (1958).

The following year, the decision of the district court was reversed, *Rosenfeld* v. *Black,* 445 F.2d 1337 (2d Cir. 1971) (Friendly, *J.*), *cert. dismissed under Rule 60,* 409 U.S. 802 (1972). Shortly thereafter, Mrs. Ruskay brought a second derivative action. This time, the complaint alleged, in keeping with *Rosenfeld,* that the excess of the price paid for W&R over its net asset value, approximately $62,000,000, represented a sale of W&R's fiduciary position. The defendants moved for summary judgment on the grounds that the settlement of the prior actions barred these suits on grounds of *res judicata* and release. The district court, Metzner, *J.*, granted the motion, 342 F.Supp. 264 (S.D.N.Y. 1972), and this appeal followed. We affirm.

As part of the settlement of the 1969 actions approved by Judge Lasker pursuant to the requirements of Rule 23.1,[3] a release was executed in favor of W&R and the individual defendants. In relevant part, it read:

3 Rule 23.1, which governs derivative actions, provides:

> The action shall not be dismissed or compromised without the approval of the court, and notice of the proposed dismissal or compromise shall be given to shareholders or members in such manner as the court directs.

This provision gives the other shareholders precisely the protection that the dissent would grant by allowing this case to proceed. The district judge, before approving a settlement, must carefully consider the interests of the absent shareholders. Upon this record, it is abundantly clear that Judge Lasker carried out this obligation fully, and concluded that a general release was appropriate under the circumstances

> United Funds, Inc., a Delaware corporation having its principal office and place of business at 20 West 9th Street, Kansas City, Missouri, for good and sufficient consideration, the receipt and adequacy of which is hereby acknowledged, does hereby release and forever discharge Waddell & Reed, Inc., a New York corporation having its principal office and place of business at 20 West 9th Street, Kansas City, Missouri, and Kansas City Securities Corporation, a Missouri corporation having its principal office and place of business at 20 West 9th Street, Kansas City, Missouri, their respective directors, officers, agents and employees and all individual defendants in the above entitled actions, including Chauncey L. Waddell, Cornelius Roach, Joe Jack Merriman and Robert W. Wagner and their respective heirs, executors, administrators and assigns of and from *any and all claims, demands or causes of action arising at any time from the beginning of the world to the date of these presents the undersigned, its successors or assigns, had, now has or may hereafter have against the aforementioned released parties, or any one or more of them, for or by reason of any of the matters or transactions recited or described in the complaints, supplemental complaints and/or other pleadings* filed by the plaintiffs in the above entitled actions saving and reserving, however, the obligations of the defendants as set forth in the Stipulation of Settlement in these actions. (emphasis added)

Appellants vigorously urge that, despite the clear language of this release, it is operative only as to the specific

claims they were pressing at the time of settlement. This contention is devoid of merit.[4]

In executing this release and paying out a substantial amount of money, the appellees sought more than relief from the particular allegations involving KCSC which were the focus of the lawsuit. The affairs of W&R and CIC had already given rise to a flood of litigation in the Southern District and the state courts of Delaware and New York. It was certainly reasonable and businesslike to seek finally to settle any allegations of wrongdoing arising out of the sale of W&R, in order that there would no longer be a cloud over the transaction. As the district court found, this was the precise intent of the settling parties. 342 F.Supp. at 271. This is the clear import of the language "any and all claims demands or causes of action . . . for or by reason of any of the matters or transactions recited or described in the complaints, supplemental complaints, and/or other pleadings . . . ." Appellants have not advanced any reason for a narrow construction of this broad language.[5]

4 We are not referred to any case, nor has our research disclosed one, in which a general release like this has been given such a construction.

Contrary to the suggestion of the dissent, it is not uncommon for general releases to be granted in settlements of derivative suits. *See, e.g., Rosenfeld* v. *Black*, 336 F.Supp. 84, 87 (S.D.N.Y. 1972). Moreover, the decision relied upon by the dissent, *Heddendorf* v. *Goldfine*, 167 F.Supp. 915, 928 (D.Mass. 1958), specifically endorses the grant of a general release under circumstances strikingly similar to those in this case.

In any event, the propriety of the grant of a general release is not before us. The time to make that objection was in the settlement hearings conducted by Judge Lasker. We are unwilling to allow one who has obtained the benefit of a settlement to object, in a subsequent proceeding, that the documents he helped draft were unfair to him.

5 Although the dissent suggests otherwise, in this case the release was referred to throughout as a "general" release. Judgment and Order of Lasker, *J.*, 67 Civ. 4175, 69 Civ. 276, June 25, 1970. Judge Lasker went on to explain that the settlement was in full satisfaction of any claim

Advised by highly competent counsel, the plaintiffs made an informed decision to grant repose to the defendants in return for a substantial sum.[6] In hindsight, the bargain appears to have been a bad one for the plaintiffs. Had they known then what they know now, it is likely that more money would have been demanded before a compromise was reached. However, the understandable desire of the plaintiffs for a larger recovery in no way limits the scope of the release they gave in an arms-length transaction. As Judge Pollack has recently stated, in determining the scope of a release similar to this one:

> Plaintiffs' claims herein, arising as they do out of a controversy pre-dating the execution of the release, might have been adjudicated at the time of its execution. Instead, plaintiff made an intelligent and knowledgeable choice to forego litigation in favor of compro-

which might arise in the future out of the "matters and transactions" recited in the pleadings. An identical broad reading of the release is given in the Notice of Settlement Hearing, which stated:

> The Stipulation of Settlement to be submitted for approval to the Court was arrived at to accomplish results deemed by both plaintiffs and defendants to be in the best interests of United and, from the viewpoint of the defendants, *to avoid further expense, inconvenience and the distraction of burdensome and protracted litigation, as well as to put at rest all contentions or controversies asserted or which might have been asserted on the basis of the matters and transactions described or referred to in the various pleadings of the plaintiffs.*

Id. at 3 (emphasis added). At no time during the settlement negotiations did plaintiffs' counsel attempt to narrow this broad language or preserve any future claim.

6 In light of the recovery now sought, we realize that $650,000 might seem an insignificant sum. However, Judge Lasker stated that it was the largest settlement, up to that time, ever received by a mutual fund in a derivative suit. In any event, the risk that a party may forfeit a huge judgment by premature settlement is simply one of the hazards of litigation, just as is the possibility that one may pay a great deal to settle a claim which turns out to be entirely unfounded.

mise. His execution of a valid release bars his claims herein.

Mittendorf v. *J. R. Williston & Beane*, 372 F.Supp. 821, 836 (S.D.N.Y. 1974).

In construing the scope of this release, we are to give effect to the intent of the parties. *Zenith Radio Corp.* v. *Hazeltine Research*, 401 U.S. 321, 342-48 (1971). Any fair reading of that intent, as demonstrated by the language of the release itself and the circumstances surrounding its execution, supports the conclusion that the plain meaning of the release bars the instant action.

There can be no question that the sale of W&R to CIC was one of the transactions recited in the pleadings, and that the current claim arises out of it. *See First Nat. Bank of Cincinnati* v. *Pepper*, slip op. 529, 546 (2d Cir. Nov. 16, 1976) (Friendly, *J.*); *Panichella* v. *Pa. R. R.*, 268 F.2d 72, 74-75 (3d Cir. 1959), *cert. denied*, 361 U.S. 932 (1960). It would have been a simple matter to except the claim now asserted from the blanket language of release.[7] *Cf. United States* v. *Allegheny-Ludlum Industries*, 517 F.2d 826, 852 (5th Cir.), *cert. denied*, 44 U.S.L.W. 3593 (April 20, 1976). The absence of any such reservation leads us to the conclusion that none was intended. The case is similar to *Dura Elec. Lamp Co.* v. *Westinghouse Elec. Corp.*, 249 F.2d 5 (3d Cir. 1957), which concerned the scope of a similar release. In that case, Judge Goodrich stated:

> It is to be noted that the language of the release is as general as language can be. There is nothing by which it may be interpreted as a covenant not to sue. There is nothing which even hints at a reservation of rights. There is nothing in the facts here which looks

7 In this connection, we note that plaintiff, represented by the same counsel, has executed a release in this action excepting certain claims.

> to a reexamination of the release based upon fraud or mutual mistake or anything of the sort. The transaction was one conducted between lawyers so we do not have an instance where a court may strive to extricate an uninformed layman from the consequences of a hasty settlement.
>
> . . .
>
> There is an affidavit by the president of the plaintiff company which figures in the district court proceedings. This affidavit does not claim that the company was lured into making this settlement. It simply says that it was not the intention of the president to release all claims against other conspirators. We think this affidavit does not change the application of the rule. When a man uses words which have a given legal effect he is bound by that effect in the absence of fraud or mistake none of which there is here.

Id. at 7 (citations omitted). *See Stella* v. *Kaiser*, 218 F.2d 64 (2d Cir. 1954) (Clark, *Ch.J.*), *aff'd on reh.*, 221 F.2d 115 (2d Cir.), *cert. denied*, 350 U.S. 835 (1955); 4 Williston on Contracts §§ 601, 603 (3d ed. 1961); *cf. Gordon* v. *Vincent Youmans*, 358 F.2d 261, 263 (2d Cir. 1965). Nor is it a valid ground for objection that plaintiffs were ignorant of the theory of recovery now advanced, inasmuch as all the litigants appear to have been aware of it.[8] The memorandum of W&R in support of the settlement explicitly discussed the possibility of recovery on this theory and found it wanting. This memorandum was available to all parties, as well as Judge Lasker, who explicitly approved the

8 The dissent suggests that Judge Tyler would not have allowed the plaintiffs to press a *Rosenfeld* claim. We can see no reason to grant relief as a result of such speculation.

settlement as fair.[9] Moreover, at the same time, plaintiffs' counsel was engaged in vigorously contesting the decision of the district court in *Rosenfeld* v. *Black, supra,* in which he ultimately succeeded. *See* R. Jennings & H. Marsh, Securities Regulation, 1559 (3d ed. 1972). He could have urged the same legal point in this action, or made mention of the possibility of such a future claim during the settlement proceedings. To now allow plaintiff to prosecute this action after giving what is, on its face, a general release would allow the defendants to be "sandbagged," a result we are not willing to countenance.[10]

Finally, it is not at all clear that this claim was not *actually* pleaded in the complaints in the Horenstein-Ruskay actions.[11] Fed.R.Civ.P. 8 abandoned the requirement that a cause of action be pleaded; instead, the complaint is to set forth "a short and plain statement" showing that the plaintiff is entitled to relief. Every element of a claim under *Rosenfeld* v. *Black* is set forth in the

9 This memorandum also discussed the desire of W&R and the individual defendants to lay to rest any legal question involving the sale to CIC.

10 Even were plaintiffs' counsel unaware of the possibilities of recovery on a *Rosenfeld* theory, a general release would still be binding as to this cause of action. *First Nat. Bank of Cincinnati* v. *Pepper,* slip op. 529, 546 (2d Cir. Nov. 16, 1976). A change in controlling law, even one grounded in the Constitution, is not a basis for reopening a judgment. *Chicot County Drainage District* v. *Baxter State Bank,* 308 U.S. 371 (1940).

The dissent suggests that a general release exceeded the authority of the party granting it. Whatever is the law as to a release of wholly unrelated claims in a derivative action, it is clear that related claims, as here, may be released under the supervision of the district court.

11 We do not intend to rest our decision on this ground, as the dissent apparently assumes. Our holding is that the clear language of the release bars the instant claim. The wide scope of the pleadings is merely one of the surrounding circumstances of the earlier action supporting that conclusion.

Horenstein-Ruskay complaints.[12] The fact that plaintiffs' counsel decided not to press these claims is merely a tac-

12 Thus, the supplemental complaint in *Horenstein* v. *Waddell & Reed* stated:

> 65. The sale to Continental of the approximately 51% of WRI's voting stock owned or controlled by Defendants Waddell and Merriman would be sufficient to transfer absolute control of WRI to Continental, thereby putting WRI and its wholly-owned subsidiary Defendant KCSC within the ownership and control of Continental.
>
> 66. Continental was formed in May 1968 and is located principally in Boston, Massachusetts, and its primary business is insuring mortgage lenders against loss on their residential mortgage loans.
>
> 67. With an eye toward their own personal profit and aggrandizement, and in total disregard of their fiduciary and legal obligations to United and United's shareholders, the Defendants Waddell and Merriman have agreed to and are preparing to sell their controlling stock to Continental, and the Defendants United, KCSC, and Roach have acted and continue to act in concert with Waddell and Merriman to facilitate such sale and to facilitate Continental's tender offer for the remaining outstanding shares of WRI.

Similar charges were made in the amended complaint in that action, as follows:

> 46. The transactions herein alleged were caused by WRI, the individual defendants and the other directors of United pursuant to a plan among them to benefit WRI and its officers, directors and stockholders, at the expense of United and its shareholders.
>
> 47. The acts of WRI and the individual Defendants, and the diversion to themselves of opportunities belonging to United, hereinbefore alleged, were and are unlawful and in violation of the Investment Advisors Act, the Investment Companies Act, the Securities Exchanges [sic] Act, the common law, and the Investment Advisory Agreements between WRI and United.
>
> 48. The acts herein alleged have been and are a gross abuse of trust, enacted in bad faith, and carried out with gross negligence and disregard by the defendants of the fiduciary duties which are imposed upon them by the law.
>
> 49. WRI and the directors, officers and stockholders of WRI, did, at all times herein mentioned, and now do, dominate and control the directors and officers of United and the policies and the conduct of the affairs of United.
>
> 50. The officers and directors of United have been at all times herein mentioned, and still are, subservient to the directions and

tical decision of the sort that is made in any litigation. Of course, if this new cause of action was actually pleaded, all parties agree that the release bars this new lawsuit.

In an era of ever-increasing caseloads, the settlement of complex lawsuits is a welcome development. Without it, judicial administration would prove an impossible task. Thus, strong policy considerations require that what all parties thought to be a closed matter remain so. One who gives a general release has had his opportunity to press his claim; before waiving his rights, he should carefully consider the possibility of a development such as the one that gave birth to this lawsuit. That risk was implicit in the settlement, and we see no reason to relieve the appellant from the consequences of his choice. Once the decision to settle is made, a party must abide by it.

> wishes of WRI, and its directors, officers and stockholders, without regard to the best interests of United.
>
> 51. The payment of excessive brokerage commissions to KCSC and other brokers, and the diversion of portions thereof as hereinbefore alleged, and the other results of the aforesaid practices, have amounted to and continue to amount to a waste and spoliation of United's assets.
>
> 52. The foregoing acts have caused substantial harm and injury to United.
>
> 53. The individual defendants have been guilty of other acts of mismanagement, malfeasance and non-feasance in their capacities as officers and/or directors of United and/or WRI, which acts constitute gross negligence, waste of corporate assets and opportunities, and fraudulent disregard of the duties and responsibilities owed by them to United.
>
> 54. Such acts of mismanagement, malfeasance, and non-feasance are also attributable to defendants WRI and KCSC.

Were the shoe on the other foot, we have no doubt that counsel would vigorously contend that these pleadings are sufficient under Rule 8 to support a *Rosenfeld* cause of action. Having made these sweeping charges of breach of fiduciary duty in verified pleadings, plaintiff will not now be heard to say that she did not really intend the broad allegations of the complaint.

In view of our disposition of this case on the ground of release, it is unnecessary to reach appellees' other contention that the claim is barred by *res judicata*. *Stella* v. *Kaiser, supra*, 221 F.2d at 116 (L. Hand, *J.*). The judgment of the district court is affirmed.

MANSFIELD, *Circuit Judge* (Dissenting):

I must dissent for the reason that in my view the record is clear that in settling and releasing the earlier Horenstein-Ruskay stockholders' derivative claims based on alleged improper brokerage activities the parties to those actions did not settle or release claims that were first asserted years later to the effect that defendants sold their investment advisory office in violation of principles outlined in *Rosenfeld* v. *Black*, 445 F.2d 1337 (2d Cir. 1971).

The two claims are entirely separate and distinct from each other. Indeed the facts giving rise to the sale-of-office claim did not occur until some two years after the brokerage accounting action had been instituted. The sale-of-office claim could not, therefore, have been asserted in the settled action without court permission, see F.R.C.P. 15(d), which was never sought or obtained for such a claim. Nor did the parties to the earlier suits, in settling the brokerage claims, indicate that sale-of-office claims were contemplated, much less settled, probably for the reason that the principles of *Rosenfeld* v. *Black* were yet to be finally established. Indeed, in seeking court approval of the settlement and release of claims for an accounting for illegal brokerage profits estimated at a few million dollars, they did not advise the court, United's stockholders, or anyone else, that they were also settling a sale-of-office claim amounting to some $62,000,000. Had they done so, it is clear that, in view of the possibility that the defendants' sale of advisory office would violate basic principles being advanced in *Rosenfeld*,

neither the district court nor United's stockholders would have authorized settlement of a claim that might be worth $62,000,000 for a mere $535,000 to $650,000. Indeed, in approving the settlement, Judge Lasker noted that when considered against the plaintiffs' claim of $2,064,000 damages the proposed settlement figure appeared to be a "respectable" one.

In short, the court, parties and United stockholders, thought they were settling brokerage claims, not a sale-of-office claim, which was never mentioned. In my view the expansive interpretation (to me a misinterpretation) given by the majority to the earlier settlement and court approval not only ignores the limited powers and purpose of the parties but it strips United and its stockholders of a valuable claim and confers an unjustifiable windfall upon the defendants.

The original Horenstein-Ruskay actions, commenced in 1967 on behalf of the investment fund United against W & R, which was investment advisor to United, and W & R's directors, claimed that the defendants channeled United's portfolio securities transactions to a W & R subsidiary, Kansas City Securities Corporation (KCSC), as the stockbroker for United and that in the handling of these United transactions on a brokerage basis the defendants engaged in various improper practices (e.g., "churning," self-dealing, improper diversion of customer-directed "give-ups," etc.) which yielded illegal profits to W & R and to its subsidiary, KCSC. The Horenstein plaintiffs sought injunctive relief, impressment of a trust, and an accounting for the profits thus alleged to have been illegally diverted by the defendants.

Following the 1969 agreement by the defendants to sell control of W & R, which had a net asset value of $18,000,000 or $18 per share, to Continental Investment

Corporation (CIC) for $80,000,000, the Horenstein plaintiffs, fearing that the individual defendants would thereby escape with the alleged ill-gotten gains realized as a result of their brokerage activities in the handling of the United account, sought leave in May, 1969, to amend their complaint by adding two new causes of action. One of the proposed new counts (the Second) claimed that the sale would deprive KCSC of its seat on the Pacific Stock Exchange, as a result of which United would incur a substantial loss, since under the investment advisory contract certain portions of KCSC's fees were remitted to United. The other proposed new count (the Third) alleged that at least part of the premium paid for the W & R shares above the net asset value of $18 per share was attributable to the illegal profits realized by W & R as a result of its improper brokerage practices in the management of the United investment fund. In short, the Horenstein plaintiffs claimed that, since the premium represented a capitalization of the illegal brokerage profits, the sale should be enjoined or the proceeds be impounded in trust for United pending the outcome of the derivative suits. At no time did the Horenstein plaintiffs claim that the defendants had violated their fiduciary duty by selling their investment advisory position; their claims were directed solely against brokerage abuses and they sought relief limited to preventing the defendants from retaining the profits (realized directly or through capitalization and sale) attributable to those abuses.

The distinct and discrete nature of the Horenstein claims was recognized by Judge Harold R. Tyler, who granted the plaintiffs' motion for leave to add the claim requesting a tracing of the allegedly ill-gotten profits, which he viewed as "substantially a request for an alternative basis for relief on the claims already stated in the complaint."

Horenstein v. *Waddell & Reed, Inc.*, 13 Fed. R. Serv. 2d 330, 333 (S.D.N.Y. 1969). The only difference the addition of this request would make, he stated, "will be on legal argument and, perhaps, an additional motion for a preliminary injunction against the tender offer and sale." *Id.*

As to that part of Horenstein's proposed supplementation that alleged direct losses to United from the sale, however, Judge Tyler denied the motion. The proposed count, he stated, had nothing to do with the churning, self-dealing, diversion of give-ups and other brokerage activities alleged in the original complaint; it arose merely out of the sale of W & R stock and the investment advisory contract between W & R and United. He held, therefore, that the court lacked the power to entertain the suit under the doctrine of pendent jurisdiction and that, even if the court did have the power, "I find that the interests of judicial economy and fairness to litigants would not be served by adding this claim to either the Horenstein action or the consolidated actions." *Id.* at 336. Thus Judge Tyler was unwilling to allow the Horenstein plaintiffs to add a claim that was not based on the alleged brokerage improprieties.

On June 4, 1969, Horenstein amended his complaint to request the tracing of profits, and plaintiff Ruskay followed suit in early July. On July 2, however, the tender offer was consummated. No trust was imposed on the proceeds. In December 1969 both suits were settled.

In the latter part of 1971, following our decision in *Rosenfeld* v. *Black*, 445 F.2d 1337 (2d Cir. 1971), *cert. dismissed*, 409 U.S. 802 (1972), Ruskay and three stockholders who had not been involved in the Horenstein-Ruskay actions brought the present suits, alleging that the sale of the W & R stock constituted a sale of fiduciary office in violation of the principles established in *Rosenfeld* v. *Black, supra.* Their claim is based not merely on the defendants' transfer of ownership of W & R to CIC at a premium but on the parties' agreement that the sale at such a premium would not become effective unless the selling defendants succeeded in obtaining for the purchaser the reinstatement of the United investment fund's advisory agreements, which would require the approval of United's directors. The defendants were alleged to have violated their fiduciary duty by accepting the premium in exchange for successfully influencing the selection of W & R's successor. Plaintiffs here appeal from the district court's order granting partial summary judgment and dismissing this claim on the grounds of res judicata.

Discussion

A stockholder-plaintiff in a derivative suit represents his company and its stockholders in a limited capacity only. He generally may settle only those disputes which are or could have been asserted by him with respect to the transactions alleged in his complaint on the company's behalf. He may not use his claims or lawsuit as the basis for releasing the defendants generally or as a means of releasing claims which could not have been advanced by him.[1]

The essential question before us, therefore, is whether the sale-of-office claim was or could have been asserted in the Horenstein-Ruskay suit. The record answers this question in the negative. The claim was never asserted

1 If claims beyond the bounds of the complaint are to be settled, the ordinary course of action is to seek amendment of the complaint to include those claims as part of the settlement. See, e.g., *Masterson* v. *Pergament*, 203 F.2d 315 (6th Cir.), *cert. denied*, 346 U.S. 832 (1953); *Cherner* v. *Transitron Electronic Corp.*, 221 F. Supp. 48, 50 (D. Mass. 1963); *Heddendorf* v. *Goldfine*, 167 F. Supp. 915, 921, 928 (D. Mass. 1958). Such a procedure is appropriate only where the new claims have been adequately and explicitly considered by the parties and the court. *Winkelman* v. *General Motors Corp.*, 48 F. Supp. 490, 495-96, *modified*, 48 F. Supp. 500 (S.D.N.Y. 1942).

in the settled lawsuit. Nor could it have been asserted, since the facts giving rise to it did not occur until long after that suit was begun, and Judge Tyler's ruling makes it clear that permission would not have been granted to add it.

The majority seek to remedy this glaring deficiency by taking the position that since the sale of W & R stock was described in the supplemental Horenstein-Ruskay complaint and the sale-of-fiduciary office claim arises out of that sale, the present plaintiffs are precluded from asserting the sale-of-office claim. The majority's analysis, however, proves too much. The claim Horenstein unsuccessfully attempted to add in the original actions—that the sale would deprive a W & R subsidiary of its exchange seat and would thereby injure United—also arose out of the sale. Thus, under the majority's analysis, that claim would similarly be barred, even though it clearly did not form and could not have formed any part of the subject matter of the Horenstein-Ruskay actions. The sale-of-office claim asserted here stands in the same position as the loss-of-exchange-seat claim which Judge Tyler refused to add to the Horenstein-Ruskay complaint. Both claims are completely unrelated to the breaches of fiduciary duty alleged in the original complaint. Both are related to the Horenstein-Ruskay action only to the extent that the sale was mentioned in the amended complaint in that action as the basis for tracing the illegal brokerage profits and the claims for loss-of-exchange seat and for sale-of-fiduciary-office also arose out of that sale. Neither could have been alleged at the time the lawsuit was filed. Both involved little additional factual proof but many additional legal problems.

Thus it is readily apparent that Judge Tyler would have denied a motion to add a *Rosenfeld* claim to the original

complaint and, under such circumstances, we have held that it must be assumed that he would have refused to add the claim. *Burns Bros.* v. *Central Railroad of New Jersey*, 202 F.2d 910 (2d Cir. 1953). In essence, what the majority has done is to hold that the representatives in the original actions settled disputes as to which they had no authority to act as representatives. In this I cannot concur.

Nor does the majority's reliance on the release executed between United and the Horenstein-Ruskay defendants, rather than on other elements of the settlement, change this analysis. The release was effective only to the extent that the Horenstein plaintiffs acted within the limits of their representation, as part of the settlement of their suits. A company cannot, as a general matter, bar derivative actions on its behalf by release.

Even if the Horenstein plaintiffs might have been permitted to assert a *Rosenfeld*-type claim, the language of the settlement documents should not be construed to bar such a claim. The release was not, as the majority contends, a general release—indeed, such a release would not ordinarily have been approved.[2] It released the defendants

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2 As the court stated in *Heddendorf* v. *Goldfine*, 167 F. Supp. 915, 928 (D. Mass. 1958), when it explicitly considered and approved a general release under the circumstances of the case:

> "While, in general, this Court has some doubt whether it is desirable for a tribunal to release defendants from liability not only for specific items of disclosed wrongdoing but also for any undisclosed wrongdoing during a defined period, the Court has no scruples in approving in this case such a general release. Here we have had the benefit of the most intensive investigation by one of the country's foremost specialists in this type of litigation. We have had an abundance of depositions. There has been a thorough canvas [sic] by a committee of Congress. This Court itself has conducted a number of hearings and has even gone so far as to open up a suggested line of evidence. On the special facts of this case, a general release is appropriate. But the special facts may not be

only from "all claims, demands or causes of action arising . . . for or by reason of any of the matters or transactions recited or described in the complaints, supplemental complaints and/or other pleadings." Although Judge Lasker referred to the release as a "general" one in his order, it is clear from the context that he meant only that it released the defendants generally from any claims arising out of the churning and self-dealing transactions forming the basis of the claims. The transactions which were the focus of the Horenstein-Ruskay actions were churning and self-dealing transactions allegedly undertaken by W & R prior to the institution of the lawsuits in 1967. The sale of W & R stock was relevant to the suits only because plaintiffs demanded that the proceeds of those churning and self-dealing transactions be traced through to the selling stockholders. No allegation was made that the defendants had breached their fiduciary duties by selling their advisory positions on condition that they would influence United to validate the purchaser (CIC) as adviser. Judge Tyler, in granting in part Horenstein's motion to supplement his complaint, viewed the tracing request simply as a remedy designed to recover the illegal brokerage profits. Although defendants' attorneys, in a passing reference, derided the possibility of a *Rosenfeld* claim in their briefs, Judge Lasker made no mention of any such claim, much less of its merit, in his order approving the settlement, even though he painstakingly and exhaustively discussed the chances of plaintiffs' success on all of the grounds alleged in their original complaints. The reason is clear: the district court did not intend to authorize settlement of

paralleled in other litigation. And so this case may not serve as a broad precedent."

Where, as here, there is no indication that the district court which approved the settlement even considered the possibility of a general release, it is wholly inappropriate for this court to infer one.

such a claim. Nor did the stockholders, who were given absolutely no notice of it in the settlement notice sent to them as mandated by F.R.C.P. 23.1.

While I agree with the majority that "the settlement of complex lawsuits is a welcome development," it should not be expanded beyond the parties' intent, particularly in representative or derivative suits where the effect is to injure innocent stockholders. Because a representative shareholder acts within a limited grant of authority when settling a dispute on behalf of all stockholders and because of the dangers inherent in representative settlements, I would construe such settlement agreements narrowly, limiting their effect to the dispute clearly before the court at the time of settlement. We have stretched the effect of representative and derivative actions far enough by allowing nonparties to be precluded merely by receipt of a notice of settlement. It is asking too much to require, as the majority apparently would here, that each stockholder consult a lawyer as to possible subtleties of language and law not set forth on the plain face of the notice and its related documents.

For these reasons I would reverse the order of the district court.

APPENDIX B

Judgment of the Court of Appeals

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

At a stated Term of the United States Court of Appeals for the Second Circuit, held at the United States Courthouse in the City of New York, on the seventeenth day of February, one thousand nine hundred and seventy-seven.

Present:

HON. WALTER R. MANSFIELD
HON. ELLSWORTH A. GRAAFEILAND
HON. THOMAS J. MESKILL

Circuit Judges

SOPHIE RUSKAY,

Plaintiff-Appellant,

—v.—

JULIUS JENSEN III, JOE JACK MERRIMAN, CHAUNCEY L. WADDELL, MONTE J. WALLACE, CORNELIUS ROACH, NEIL W. WALLACE, MITCHEL J. VALICENTI, John Doe 1 to John Doe 100, Richard Roe 1 to Richard Roe 1000 (fictitious names, the true names being unknown to plaintiffs, the parties intended being those other than any defendant above named, who in 1969 sold stock of Waddell & Reed, Inc., to Continental Investment Corp.) Waddell & Reed, Inc., (a Mass. Corp.) previously known as CWR Corp., Continental Investment Corp., and United Funds, Inc.,

Defendants-Appellees.

WEBSTER FACTORS, INC.,

Plaintiff-Appellant,

—v.—

CHAUNCEY L. WADDELL, RICHARD H. WADDELL, THEODORE H. WADDELL, MITCHELL J. VALICENTI, ROBERT PERSONS, JAMES W. KEMPER, JR., JACK D. MERRIMAN, CORNELIUS ROACH, GERALD A. GILVERT, JOE JACK MERRIMAN, EDGAR SHOOK, CAMERON K. REED, DUTTON BROOKFIELD, JAY B. DILLINGHAM, CLARENCE D. FELL, JACKSON W. GOSS, W. HARDY HENDRON, JULIUS JENSEN III, JOHN A. KROH, THOMAS C. MACLAUGHLIN, WILLIAM A. REASONER, CARL B. SCHUTZ, MONTE J. WALLACE, NEIL W. WALLACE, JOHN B. WORNALL, WADDELL, & REED, INC., (a N. Y. Corp.) WADDELL & REED, INC., (Mass. Corp.), CONTINENTAL INVESTMENT CORP., UNITED FUNDS, INC.,

Defendants-Appellees.

IRWIN L. FEINBERG, as Trustee for HELEN K. FEINBERG, and IRWIN L. FEINBERG, and HELEN K. FEINBERG, as Joint Tenants,

Plaintiffs-Appellants,

—v.—

JULIUS JENSEN III, JOE JACK MERRIMAN, CHAUNCEY L. WADDELL, MONTE J. WALLACE, CORNELIUS ROACH, etc.,

Defendants-Appellees.

LOUIS FELDMAN,

Plaintiff-Appellant,

—v.—

JOE JACK MERRIMAN, *et al.,*

Defendants-Appellees.

JUDITH BERNSTEIN, *et al.,*

Plaintiff-Appellant,

—v.—

DUTTON BROOKFIELD, *et al.,*

Defendants-Appellees.

Apppeal from the United States District Court for the Southern District of New York.

This cause came on to be heard on the transcript of record from the United States District Court for the Southern District of New York, and was argued by counsel.

ON CONSIDERATION WHEREOF, it is now hereby ordered, adjudged, and decreed that the judgment of said District Court be and it hereby is affirmed in accordance with the opinion of this court with costs to be taxed against the appellants.

A. DANIEL FUSARO,
Clerk

By VINCENT A. CARLIN,
Chief Deputy Clerk

APPENDIX C

Decision of the Court of Appeals Denying Petition for Rehearing

UNITED STATES COURT OF APPEALS

SECOND CIRCUIT

At a stated term of the United States Court of Appeals, in and for the Second Circuit, held at the United States Court House, in the City of New York, on the ninth day of May, one thousand nine hundred and seventy-seven.

Docket No. 76-7270

SOPHIE RUSKAY, LOUIS FELDMAN, Trustee, etc.,

Plaintiffs-Appellants,

—v.—

CHAUNCEY L. WADELL, etc.,

Defendants-Appellees.

A petition for rehearing containing a suggestion that the action be reheard en banc having been filed herein by counsel for the plaintiffs-appellants, and no active judge or judge who was a member of the panel having requested that a vote be taken on said suggestion,

UPON CONSIDERATION THEREOF, it is

ORDERED that said petition be and it hereby is DENIED.

IRVING R. KAUFMAN,
Chief Judge.

APPENDIX D

Opinion of the District Court

Sophie BUSKAY, Plaintiff,
v.
Julius JENSEN, III et al., Defendants (and three other consolidated actions).

Nos. 71 Civ. 3169, 71 Civ. 4424, 71 Civ. 3865 and 71 Civ. 4352.

United States District Court, S. D. New York.
March 25, 1972.

Action by shareholders of a mutual fund against corporate investment advisor, directors and officers of advisor and corporation, which had acquired over 90 percent of outstanding shares of advisor and merged advisor into its subsidiary, to recover profits made by investment advisor's shareholders when they sold their stock. The defendants moved for summary judgment. The District Court, Metzner, J., held that where successive actions involved claim for same premium paid on sale of same stock in same corporation pursuant to same contract between same parties as part of same tender offer, the one right asserted in both actions was that of the mutual fund to profits made upon sale of its investment advisor and principal underwriter and the single legal wrong was breach by defendants of their fiduciary duty to refrain from making personal profits upon sale of assets properly belonging to the fund, the second action was barred by res judicata.

Judgment accordingly.

1. Judgment ⟹713(2), 720

Judgment in prior suit, if rendered on merits, is res judicata in subsequent action between same parties on same claim or cause of action and operates as absolute bar not only as to every ground of recovery or defense actually presented in prior action, but also as to every ground which might have been presented, but where second action is upon different claim or demand, prior judgment

operates as estoppel only as to those issues actually litigated and determined in prior suit.

2. Judgment ⟹701

For res judicata purposes, inasmuch as real party in interest as plaintiffs in both suits was mutual fund and its shareholders, plaintiffs were the same, even though the named plaintiffs might differ.

3. Judgment ⟹570(5)

Judgment approving settlement and dismissing complaint as to all claims which were or might have been asserted in them with respect to matters and transactions alleged was a "judgment on the merits" and would be given full res judicata effect in subsequent suit between same parties on same causes of action as those compromised in settlement.

See publication Words and Phrases for other judicial constructions and definitions.

4. Judgment ⟹570(3)

Settlement decree dismissing complaint as to all claims which were or might have been asserted as to matters and transactions alleged eliminated need to have issues actually litigated and, since it was unaccompanied by findings of fact or conclusions of law, it generally could not bind parties as to any issues which might arise in subsequent lawsuit on different cause of action.

5. Judgment ⟹585(2)

For res judicata purposes, two causes of action are the same if they allege violation of but one right by single legal wrong.

6. Judgment ⟹585(2)

Where claims for relief in two lawsuits depend on same operative facts and pertain to same disputed transactions, they constitute the same cause of action for res judicata purposes.

7. Judgment ⟹585(2)

Where successive actions involved claim for same premium paid on sale of same stock in same corporation pursuant to same contract between same parties as part of same tender offer and the one right asserted in both actions was that of mutual fund to profits made upon sale of its investment advisor and principal underwriter, and the single legal wrong was breach by defendants of their fiduciary duty to refrain from making personal profits upon sale of assets properly belonging to fund, second action was barred by res judicata. Investment Company Act of 1940, § 1 et seq., 15 U.S.C.A. § 80a-1 et seq.

8. Action ⟹53(1)

Plaintiff cannot split up his claim and cannot divide grounds for recovery.

9. Compromise and Settlement ⟹16(1)

Where mutual fund shareholders framed complaint in first action to avoid effect of prior decision that premium received upon sale of shares of investment advisor does not constitute sale of fiduciary offices, shareholders were barred, after settling that case, from maintaining action against same defendants on basis of later decisions that stockholders of investment advisor must account to mutual fund for any profits received upon sale of their shares. Investment Company Act of 1940, § 1 et seq., 15 U.S.C.A. § 80a-1 et seq.

10. Judgment ⟹589(1)

When plaintiff has two alternate remedies available to him upon same cause of action, he may not reserve one and sue upon the other and judgment on one will be bar to later suit upon the other.

11. Judgment ⟹587

Fact that decision on one theory of recovery will have no bearing on determination of another does not mean that each theory states a distinct cause of action for res judicata purposes.

12. Judgment ⟹632

Where plaintiff, mutual fund shareholders chose the forum in prior action, had complete discovery on all issues, voluntarily surrendered mutual fund's claims in exchange for settlement payment and were fully aware of role

played by certain persons, who were not parties and whose participation in challenged transactions was not independent of that of defendants, judgment in that case was a bar to shareholders' subsequent action against such persons and doctrine of mutuality of estoppel did not preclude defensive use of res judicata. Investment Company Act of 1940, § 1 et seq., 15 U.S.C.A. § 80a-1 et seq.

13. Release ⟹27

Where plaintiff mutual fund shareholders executed release discharging liability of defendant investment advisor's officers and directors, such release also discharged advisor's officers and directors who were not parties to the action and they were not subject to suit in later action for the same relief. Investment Company Act of 1940, § 1 et seq., 15 U.S.C.A. § 80a-1 et seq.

14. Release ⟹38

Effect of release is governed by intention of parties.

15. Release ⟹27, 38

Where shareholders in investment advisor were motivated to settle action against them by shareholders of mutual fund by the imminent sale of their stock in advisor, so that it was inconceivable that parties could have intended to remove liability from sellers of advisor's stock only to cast it upon buyers, release signed by shareholders of investment fund released all parties to the transaction, precluding subsequent action against corporation which acquired shares of advisor. Investment Company Act of 1940, § 1 et seq., 15 U.S.C.A. § 80a-1 et seq.

Pomerantz, Levy, Haudek & Block, New York City, for plaintiffs; William E. Haudek, New York City, of counsel.

Valicenti, Leighton, Reid & Pine, New York City, for defendants; Albert D. Jordan and Elliot Paskoff, New York City, of counsel.

METZNER, District Judge:

The defendants move pursuant to Rule 56(b), Fed.R.Civ.P., for summary judgment on the ground that all of the claims asserted in these four consolidated stockholders' derivative suits are barred by a judgment of this court entered on June 25, 1970 in an earlier stockholders' derivative suit.

The named plaintiffs in each of the four present actions are shareholders of United Funds, Inc. [United], and were shareholders during the time of the transactions complained of. They sue on behalf of United and all United shareholders.

United is a mutual fund registered under the Investment Company Act of 1940, 15 U.S.C. § 80a-1 et seq. [the Act], as an open-end management investment company. As of June 1969, it had assets in excess of $2 billion and more than 500,000 shareholders holding more than 275 million shares of stock.

Defendant Waddell & Reed, Inc. [W & R] was the investment adviser for United in 1969 and for many years prior thereto. During this same period of time W & R also acted as the principal underwriter for United's shares. Defendants Roach, Waddell, Merriman and Valicenti were directors and officers of W & R during this time.

Defendant Continental Investment Corporation [CIC] is a Massachusetts corporation. CWR Corporation, also a Massachusetts corporation, is a wholly-owned subsidiary of CIC. CIC acquired over 97% of the outstanding shares of W & R, merged W & R into its subsidiary, CWR, and changed the latter's name to Waddell & Reed, Inc. [W & R/Mass.]. Defendants Jensen, M. J. Wallace and N. W. Wallace are directors and officers of CIC.

All four complaints, with some exceptions to be mentioned later, are basically the same and seek, in essence, to recover profits made by W & R shareholders when they sold their stock to CIC.

CIC's acquisition of W & R had its origins in a contract executed in early

1969 between CIC and the holders of 61.69% of W & R's voting stock, including defendants Waddell, Merriman and Roach. Pursuant to that contract, CIC agreed to purchase this block of stock at a price of $80 per share and to make a tender offer for the remaining outstanding shares of W & R at the same price. At the time the contract was executed, W & R stock had a par value of $1 per share and a net asset value of approximately $18 per share.

The parties to the contract understood that under the Act the advisory and underwriting agreements between United and W & R would automatically terminate upon acquisition of W & R by CIC. Therefore, CIC's obligations were expressly conditioned upon reinstatement by United's shareholders of the advisory agreement and reinstatement by United's directors of the underwriting agreement.

On April 18, 1969, United's management called a shareholders' meeting for June 3, 1969, and sent to all fund shareholders a proxy statement describing the arrangement with CIC, seeking approval for reinstatement of the advisory agreement upon consummation of the deal, and soliciting votes for re-election of the 15 incumbent directors of United. On June 3rd, the shareholders approved reinstatement of the advisory agreement and re-elected the 15 incumbent directors.

The complaints charge that the excess of purchase price over net asset value of the W & R shares constitutes payment for W & R's fiduciary positions as investment adviser and principal underwriter for United. It is claimed that this sale of fiduciary offices is illegal and that the excess, amounting to $62 per share, should have been paid to United rather than to the stockholders of W & R.

It is further alleged that the April 18th proxy statement was materially false and misleading in that it failed to reveal that United and its shareholders were entitled to the profits to be made upon the sale of W & R shares and by representing that CIC contemplated no changes in the board of directors of United or in the management of W & R upon consummation of the acquisition. The complaints charge that because of these defects in the proxy statement the reinstatement of the advisory and underwriting agreements was void and the defendants must account to United for all fees received under the reinstated agreements.

One of the plaintiffs makes an additional claim based on alleged misrepresentations in proxy material sent to United's shareholders on April 30, 1971. This proxy material sought approval of an amendment to the advisory contract to increase advisory fees paid by United to the investment adviser. The complaint charges that the stockholders' subsequent approval of the amendment was void because it was based on misrepresentations in the proxy material.

The defendants claim that a judgment of this court entered on June 25, 1970 in two earlier stockholders' derivative suits is res judicata on all the issues raised by the present plaintiffs.

The first of these two actions, Horenstein v. Waddell & Reed, Inc., 67 Civ. 4175, was commenced on October 26, 1967, and the second, Ruskay v. Merriman, 69 Civ. 276, on January 23, 1969. The initial complaints in both suits were largely identical and charged that W & R had breached its fiduciary duty to United by channeling portfolio transactions through a wholly-owned subsidiary which acted as broker for United without reducing the management fee charged United. Allegations were also made that transactions for United were used by W & R to gain reciprocal trade and give-up agreements for W & R with other brokers.

In May 1969 plaintiffs in the Horenstein/Ruskay actions, having learned of CIC's acquisition offer, moved and were granted leave to file supplemental complaints alleging that the W & R shareholders were going to

receive an excessive price for their shares. It was alleged that the price was largely a result of the ability of the investment adviser of United to earn substantial illegal profits in its management of the fund, as alleged in the principal complaint. It was claimed that these illegal profits resulted from a breach of fiduciary duty, and therefore the premium paid for them was rightfully the property of United.

In answer to the supplemental complaints, defendants denied these allegations, and stated that the shareholders approved the transaction after "full and fair disclosure" in the proxy statement by voting for the reinstatement of the advisory agreement.

On December 24, 1969, the parties in the Horenstein/Ruskay actions entered into a stipulation of settlement whereby the defendants agreed to pay United a total of $650,000 in exchange for dismissal of the complaints with prejudice. On June 25, 1970, after a hearing pursuant to notice to stockholders, Judge Lasker entered judgment approving the settlement and dismissed the complaints on the merits and with prejudice as to "any and all claim or claims, or causes of action, or parts thereof which are or might have been asserted with respect to the matters and transactions alleged in the said complaints. . . ." On October 10, 1970, United executed a release discharging all defendants named in the Horenstein/Ruskay actions from any and all claims United had or might have against them "for or by reason of any of the matters or transactions recited or described in the complaints, supplemental complaints and/or pleadings filed by the plaintiffs in the above entitled actions. . . ."

[1] Any discussion of the issues presented by this motion must begin with the classic statement of the rules of res judicata and collateral estoppel set forth in Cromwell v. County of Sac, 94 U.S. 351, 24 L.Ed. 195 (1876). According to that case, the judgment in a prior suit, if rendered on the merits, is res judicata in a subsequent action between the same parties on the same claim or cause of action and operates as an absolute bar not only as to every ground of recovery or defense actually presented in the prior action, but also as to every ground which might have been presented. However, where the second action is upon a different claim or demand, the prior judgment operates as an estoppel only as to those issues actually litigated and determined in the prior suit. See also Lawlor v. National Screen Service Corp., 349 U.S. 322, 326, 75 S.Ct. 865, 99 L.Ed. 1122 (1955); Commissioner of Internal Revenue v. Sunnen, 333 U.S. 591, 597, 68 S.Ct. 715, 92 L.Ed. 898 (1948); Baltimore Steamship Co. v. Phillips, 274 U.S. 316, 319, 47 S.Ct. 600, 71 L.Ed. 1069 (1927).

These rules raise five basic questions:

(1) Were the parties in the prior action the same as in the present one?

(2) Did the prior action go to judgment?

(3) If so, was that judgment on the merits?

(4) Were the claims or causes of action in the prior suit the same as in the present one?

(5) If not, what issues were actually litigated and determined in the prior suit?

[2] The first three of these questions are easily disposed of in the present litigation. Both the Horenstein/Ruskay actions and the instant suits were brought derivatively on behalf of United and its shareholders, and therefore the plaintiffs in all actions are the same. The real party in interest in these suits is the fund and its shareholders, even though the named plaintiffs might be different in each case. Of the defendants, W & R Merriman, Roach and Waddell are parties in all the actions. The effect of Horenstein/Ruskay on those who were not named in that suit will be discussed later.

[3, 4] As to the second question, on June 25, 1970 a judgment was entered in the Horenstein/Ruskay actions approving the settlement and dismissing the complaints as to all claims which were or might have been asserted in them with respect to the matters and transactions alleged. Such a settlement decree is a judgment on the merits and is given full res judicata effect in a subsequent suit between the same parties on the same causes of action as those compromised in the settlement. Smith v. Alleghany Corp., 394 F.2d 381, 391 (2d Cir.), cert. denied, 393 U.S. 939, 89 S.Ct. 300, 21 L.Ed.2d 276 (1968); Stella v. Kaiser, 218 F.2d 64, 65 (2d Cir. 1954), cert. denied, 350 U.S. 835, 76 S.Ct. 71, 100 L.Ed. 745 (1955). However, the collateral estoppel effect of a settlement decree is greatly limited. Since a settlement such as the one in Horenstein/Ruskay eliminates the need to have issues actually litigated and is unaccompanied by findings of fact or conclusions of law, it generally cannot bind the parties as to any issues which might arise in a subsequent lawsuit on a different cause of action. Lawlor v. National Screen Service Corp., *supra*.

This brings us to the heart of the present controversy: whether the causes of action in Horenstein/Ruskay are the same as those here. A determination of this issue requires analysis of the various claims asserted in the present and prior suits.

In the Horenstein/Ruskay actions two basic claims were raised:

1. A claim, asserted in the principal complaints, to recover illegal profits made by W & R as manager of United;

2. A claim, asserted in the supplementary complaints, to recover the premium to be paid W & R shareholders by CIC as payment for past and future illegal profits obtainable as manager of United.

A/In the present litigation, three distinct claims can be culled from the complaints:

1. A claim for the excess of purchase price over net asset value of the W & R shares, based on a charge that this excess constitutes payment for W & R's fiduciary offices as investment adviser and principal underwriter for United;

2. A claim for profits made under the reinstated advisory and underwriting agreements, based both on misrepresentations in the proxy statement of April 18, 1969, and on the illegality of the sale of fiduciary offices;

3. A claim for profits made under the advisory agreement as amended in 1971, based on misrepresentations in the proxy material of April 30, 1971.

The major dispute between the parties here is whether the first claim in the present suits is identical to the claim asserted in the supplemental complaints in the Horenstein/Ruskay actions. The court concludes that it is, and it is therefore barred by res judicata./A

[5, 6] Two causes of action are the same if they allege "the violation of but one right by a single legal wrong." Baltimore Steamship Co. v. Phillips, *supra* 274 U.S. at 321, 47 S.Ct. at 602. Where the claims for relief in two lawsuits depend on the same operative facts and pertain to the same disputed transactions, they constitute the same cause of action. Saylor v. Lindsley, 391 F.2d 965, 969 n. 6 (2d Cir. 1968); Engelhardt v. Bell & Howell Co., 327 F.2d 30, 33 (8th Cir. 1964); Williamson v. Columbia Gas & Electric Corp., 186 F.2d 464, 470 (3rd Cir. 1950), cert. denied, 341 U.S. 921, 71 S.Ct. 743, 95 L.Ed. 1355 (1951).

[7] Such is the case here. Both Horenstein/Ruskay and the present case involve a claim for the same premium paid in the same sale of the same stock in the same corporation pursuant to the same contract between the same parties as part of the same tender offer. The one right asserted in both actions is the right of United to the profits made upon sale of its investment adviser and principal underwriter. The single legal

wrong is the breach by defendants of their fiduciary duty to refrain from making personal profits upon a sale of assets properly belonging to United.

The fact that the settling plaintiffs alleged a formula for computing damages different from that urged here is not a distinguishing factor between the two sets of cases. In the former the premium paid for the stock was alleged to be a capitalization of the illegal profits which could be made from the management contracts. In the instant cases the premium is alleged to have been paid for reinstatement of the contracts under which W & R was making its illegal profits. However denominated, it is the same asset which is in dispute in both actions. The management contracts were inseparable from the profits which could be made from them.

[8] If the plaintiffs here were to be successful in their claims, United would be recovering the same premium twice. Obviously such a result is inconceivable. A plaintiff "cannot even split up his claim . . . ; and, *a fortiori*, he can not divide the grounds for recovery." United States v. California & Oregon Land Co., 192 U.S. 355, 358, 24 S.Ct. 266, 267, 48 L.Ed. 476 (1904).

The instant case presents a situation similar to the one in Chicot County Drainage District v. Baxter State Bank, 308 U.S. 371, 60 S.Ct. 317, 84 L.Ed. 329 (1940). In that case, plaintiff sought to avoid the res judicata effect of a prior judgment by arguing that the statute pursuant to which the court had acted was subsequently declared unconstitutional in an unrelated case. The Supreme Court rejected this argument, stating that since plaintiff had an opportunity in the prior proceeding to litigate the constitutionality of the statute and failed to do so, it was bound by the prior determination.

[9, 10] When the supplemental complaints in the Horenstein/Ruskay actions were filed, the leading authority on the accountability of an investment adviser for profits made on the sale of its shares was Securities and Exchange Commission v. Insurance Securities, Inc., 254 F.2d 642 (9th Cir.), cert. denied, 358 U.S. 823, 79 S.Ct. 38, 3 L.Ed. 2d 64 (1958). This case held that a management contract is not an asset of the fund, and that a premium received upon the sale of shares in the investment adviser does not constitute a sale of fiduciary offices. Rather than conducting a frontal assault upon the *Insurance Securities* rule, the Horenstein/Ruskay plaintiffs sought to skirt the issue. They scrupulously avoided using "fiduciary offices" language in their supplemental complaints, instead terming the premium a payment for illegal profits. The memoranda submitted in support of the proposed settlement show that one reason for settling was plaintiffs' recognition that the *Insurance Securities* case made recovery on the supplemental complaints doubtful. Then in 1971 the Second Circuit decided Rosenfeld v. Black, 445 F.2d 1337 (2d Cir. 1971), appeal pending, which rejected the *Insurance Securities* rule and held that stockholders of an investment adviser must account to the fund for any profits received upon sale of their shares. In the wake of this decision, the present plaintiffs initiated their lawsuits. However, as in the *Chicot* case, *supra*, it is clear that plaintiffs in Horenstein/Ruskay had an opportunity to attack *Insurance Securities* and chose not to do so. Now that *Insurance Securities* has been successfully challenged, plaintiffs cannot reap the benefits of a claim which was consciously avoided before. When a plaintiff has two alternate remedies available to him upon the same cause of action, he may not reserve one and sue upon the other. A judgment on one will be a bar to a later suit upon the other. United States v. California & Oregon Land Co., *supra*; Burns Bros. v. Central R.R. of New Jersey, 202 F.2d 910, 913 (2d Cir. 1953).

Plaintiffs urge that proof of the claim here would require evidence different from that needed to prove the first actions. The "same evidence" test may be useful as a positive test for determining the identity of claims, but it is not valid as a negative test. Engelhardt v. Bell & Howell Co., *supra* 327 F.2d at 34.

[11] It will often be true that a decision on one theory of recovery will have no bearing on the determination of another. This does not mean that each theory states a distinct cause of action. For example, in Baltimore Steamship Co. v. Phillips, *supra*, the Court held that a claim of negligence based on the use of defective machinery was identical to a claim of negligence in regard to the same injury against the same defendant based on negligent operation of that machinery. Nonetheless, it cannot be disputed that a determination that the machinery was not defective would not have precluded a finding that it was operated negligently.

Plaintiffs further contend that, in any event, the judgment in Horenstein/Ruskay cannot bar their claim insofar as it is asserted against those defendants who were not parties to the earlier suits. They rely on the doctrine of mutuality of estoppel. However, the mutuality requirement has been greatly diluted in the Second Circuit by Zdanok v. Glidden Co., 327 F.2d 944 (2d Cir.), cert. denied, 377 U.S. 934, 84 S.Ct. 1338, 12 L.Ed.2d 298 (1964). The court there held that in a proper case mutuality should not be used to preclude defensive use of res judicata against a person who was a party to the earlier litigation. This approach has recently been approved by the United States Supreme Court. Blonder-Tongue Laboratories, Inc. v. University of Illinois Foundation, 402 U.S. 313, 91 S.Ct. 1434, 28 L.Ed.2d 788 (1971).

[12] The present case is a proper one for dispensing with the mutuality requirement. The plaintiffs in Horenstein/Ruskay chose the forum in which they litigated, had complete discovery on all issues, and voluntarily surrendered United's claims in exchange for the $650,000 settlement payment. Furthermore, they were fully aware of the role played by the present defendants who were not parties to the earlier proceeding. The participation of these defendants in the challenged transactions was not independent of that of the other defendants, and in fact in the present complaint they are named merely as "co-conspirators with the Horenstein/Ruskay defendants.

[13] In any event, regardless of questions of mutuality, the court holds that the release executed by the plaintiffs in Horenstein/Ruskay has discharged all present defendants, including those who were not parties to that action. W & R, its officers and directors are within the express terms of the release.

[14, 15] The other defendants, CIC and persons associated with it, may also take advantage of the release. The effect of a release is governed by the intentions of the parties. Zenith Radio Corp. v. Hazeltine Research, Inc., 401 U.S. 321, 342-348, 91 S.Ct. 795, 28 L.Ed.2d 77 (1971). In the present case the conclusion is inescapable that the parties in Horenstein/Ruskay intended their release to discharge all persons involved in the CIC acquisition transaction. The memoranda in support of the settlement point out that a major factor motivating the defendants to settle was the imminent sale of their stock to CIC. The defendants desired to remove all potential clouds on that stock before transferring it to CIC. It is inconceivable that the parties could have intended to remove liability from the sellers only to cast it upon the buyers. The plaintiffs must have intended to release all parties to the transaction.

This leaves for consideration the remaining two claims asserted by plaintiffs in the present cases. As mentioned above, these claims relate to profits made under the advisory and underwriting agreements between United and W & R after the CIC acquisition and profits made under the amended 1971 advisory agreement.

It is clear that these claims constitute causes of action separate and distinct from any asserted in the Horenstein/Ruskay suits and are not barred by the prior actions.

Defendants' motion for summary judgment is disposed of in accordance with the above opinion.

So ordered.

APPENDIX E

Notice of Horenstein-Ruskay Settlement Hearing

NOTICE OF SETTLEMENT HEARING

UNITED STATES DISTRICT COURT SOUTHERN DISTRICT OF NEW YORK, Fred Horenstein and Joseph Sciuto, Plaintiffs, against Waddell and Reed, Inc., Joe Jack Merriman, Chauncey L. Waddell, Cornelius Roach, United Funds, Inc., and Kansas City Securities Corporation, Defendants, 67 Civ. 4175, Action No. 1.

UNITED STATES DISTRICT COURT SOUTHERN DISTRICT OF NEW YORK, Sophie Ruskay, Plaintiff, against Joe Jack Merriman, Chauncey L. Waddell, Cornelius Roach, Cameron K. Reed, Robert W. Wagner, Waddell & Reed, Inc., Kansas City Securities Corporation and United Funds, Inc., Defendants, 69 Civ. 276, Action No. 2.

TO THE SHAREHOLDERS OF UNITED FUNDS, INC.:

NOTICE IS HEREBY GIVEN that a hearing will be held at Room 1306 of the United States Courthouse at Foley Square in the City, County and State of New York at 11 o'clock in the morning of the 6th day of April, 1970 pursuant to an order of this Court, dated December 24, 1969, to determine whether the proposed settlement and compromise of the above entitled shareholder actions brought derivatively on behalf of and in the right of United Funds, Inc. ("United") should be approved and confirmed by the Court in accordance with the Federal Rules of Civil Procedure as fair, reasonable and adequate and, if such settlement and compromise be approved, the allowances, if any, to be made to plaintiffs for legal fees and other expenses. The hearing may be adjourned from time to time by the Court at the hearing or at any adjourned session thereof without further notice.

Any shareholder of United who desires to do so may appear at such hearing and show cause, if any he has, why the settlement and compromise hereinafter described should not be approved, and why these actions should not be dismissed on the merits and with prejudice, and may present any evidence that may be proper and relevant to the issues to be heard; provided, however, that no person not a party shall be heard and no papers or briefs submitted by any such person shall be received and considered except by special permission of the Court, unless on or before the 27th day of March, 1970, notice of intention to appear and copies of such papers and briefs are filed in the Court and served upon Messrs. Bass & Friend, 16 West 61st Street, New York, N. Y. (Counsel for plaintiffs in Action No. 1); on Joseph A. Ruskay, Esq., 122 East 42nd Street, New York, N. Y. 10021 (Counsel for plaintiff in Action No. 2); and on Messrs. Valicenti Leighton Reid & Pine, 70 Pine Street, New York, N. Y. 10005 (Counsel for the defendants other than United).

SUMMARY OF THE ISSUES AND CONTENTIONS

The *Horenstein* action (Action No. 1) was filed on October 26, 1967. The plaintiffs' amended complaint in that action, filed June 6, 1968, alleges, in substance, that the affairs of United and its Board of Directors were dominated and controlled by Waddell & Reed, Inc. ("W&R") (its investment adviser and manager) and the defendants who are associated with W&R; that the defendants were engaged in a conspiracy to enrich themselves and their associates

at the expense of United; that W&R has exploited its power over the execution of the portfolio transactions of United by directing the execution of such transactions to its wholly-owned subsidiary Kansas City Securities Corporation ("KCSC") and to other brokers or dealers who share their commissions or discounts on such transactions, directly or indirectly, through so-called "give-ups" and/or various reciprocal arrangements with KCSC and other brokers or dealers who furnish information or services to W&R or who sell shares of United; that such practices have deprived United of the best execution of its portfolio transactions and have resulted in the execution of United's portfolio transactions at less favorable prices than were otherwise available and/or at higher brokerage costs; that such practices have enabled W&R and the defendants associated with it to derive substantial profits and benefits by reducing the cost to W&R of performing the investment advisory and management services required by its contract with United as well as by increasing the management fee of W&R through stimulating thereby the sale of United's shares. Such complaint further alleges that the formulae in effect at various times since September 1, 1965 for the reduction of the management fee payable by United to W&R by an amount equal to a portion (currently 50%) of the net income of KCSC is improper and illegal to the extent such arrangement permits W&R to benefit from the commissions or discounts paid by United for the execution of its portfolio transactions; and that the annual approval by United's shareholders of the terms of the investment advisory and management contracts with W&R in effect since 1965 which provide for such formula was procured by proxy statements for the annual meetings of such shareholders which were "false or fraudulent" in that they failed to disclose the alleged acts and practices of the defendants and their intent to engage in such acts and practices. In addition, the complaint in the *Horenstein* action (Action No. 1) alleges that the individual defendants have been guilty of "other acts of mismanagement, malfeasance and nonfeasance . . . as officers and/or directors of United."

The complaint in the *Ruskay* action (Action No. 2), which was filed on January 23, 1969, alleges matters substantially the same as those alleged in the *Horenstein* action and, in addition, also alleges that the defendants have caused excessive turnover of United's portfolio securities in order to increase the benefit being derived from the commissions or discounts paid by United on the purchase or sale of its portfolio securities.

The defendants have denied each and every allegation of wrongdoing on their part as both unwarranted and factually inaccurate; have disclaimed any liability therefor and have, in addition, asserted affirmative defenses to the effect that the shareholders of United have ratified, approved and shared in the benefit of the practices followed by W&R in handling the execution of United's portfolio transactions; that some or all of the claims are barred by laches and limitations; and that the contentions advanced by the plaintiffs in these actions relating to the alleged abuse by W&R of its control over the execution of United's portfolio transactions are repetitious of substantially identical claims made in an earlier series of stockholder actions also brought purportedly on behalf of United, including an action instituted by the plaintiff in the *Ruskay* action (Action No. 2), which claims were dismissed on their merits as part of a settlement approved, after a hearing on notice to all shareholders of United, by an order of the Supreme Court of the State of New York, New York County, dated March 29, 1965.

In October of 1968, plaintiffs in the *Horenstein* action (Action No. 1) instituted a separate action in the Supreme Court of the State of New York, New York County, alleging, in effect, that the formula arrangement by which KCSC is entitled to retain revenues directly or indirectly derived from the execution of United's portfolio transactions in exchange for a proportionate reduction in the management fees of W&R constituted a breach of the terms arranged for the settlement of the previously mentioned series of earlier stockholder actions as well as a violation of the 1965 order of that Court approving the settlement. The defendants assert that such claims are based on a distorted interpretation of such settlement terms and that the acts and practices of W&R found objectionable by plaintiffs have been authorized by the terms of the investment advisory and management agreements in effect between W&R and United since 1965 pursuant to the requirements of the very settlement stipulation on which plaintiffs rely. Because of the similarity of such issues with the previously described issues pleaded in the actions before this Court, prosecution of such action has been stayed by an order of the Supreme Court, New York County, dated May 12, 1969, pending the final determination of the actions pending in this Court. The complaint of the plaintiffs in the *Horenstein* action before this Court has been amended to include the allegations of their complaints before the Supreme Court of the State of New York.

By supplemental complaints filed by the *Horenstein* plaintiffs on June 5, 1969 and by the plaintiff in the *Ruskay* action on July 7, 1969, it is alleged that the defendants Waddell, Merriman and Roach arranged to sell a majority of the voting shares of W&R held by themselves and members of their families at a price of $80 per share; that such price was largely attributable to the profits derived by W&R from the acts, transactions and practices complained of in their principal complaints; and that the proposed sale should be enjoined or the proceeds thereof sequestered for the benefit of United. The defendants involved in such allegations have denied that they are accountable to United or its shareholders for the selling price of their W&R shares or that such selling price was dependent on or affected by any of the improprieties or wrongdoing alleged by plaintiffs; and that, after full disclosure on the matter, the shareholders of United, on June 3, 1969, approved the reemployment of W&R as investment adviser and manager of United in the event that control of W&R should be acquired by the purchaser of their shares.

SUMMARY OF SETTLEMENT TERMS

The Stipulation of Settlement to be submitted for approval to the Court was arrived at to accomplish results deemed by both plaintiffs and defendants to be in the best interests of United and, from the viewpoint of the defendants, to avoid further expense, inconvenience and the distraction of burdensome and protracted litigation, as well as to put at rest all contentions or controversies asserted or which might have been asserted on the basis of the matters and transactions described or referred to in the various pleadings of the plaintiffs.

The Stipulation of Settlement provides, in substance, that the defendants will pay or cause to be paid to United a total of $650,000 of which sum a total of $500,000 will be paid by KCSC or W&R in five annual installments each in the amount of $100,000 commencing within thirty (30) days of the effective date of the Stipulation of Settlement. Thus, if the settlement is approved and the action instituted by the *Horenstein* plaintiffs in the Supreme Court of the State of New York, New York County, is finally dismissed (which result is anticipated because of the settlement), United will receive the sum of $250,000 within thirty (30) days of the effective date of the settlement and additional installments of $100,000 within thirty (30) days of the next four (4) anniversaries of the effective date of the settlement.

The Settlement Stipulation further provides that the amount of each installment, to the extent paid by KCSC, may be treated as a deduction in the computation of the net income of KCSC for purposes of the formula under which the management fee of United is reduced by a portion of the net income of KCSC as provided in the investment advisory and management agreement now or hereafter in effect between United and W&R. In the event the Stipulation of Settlement is approved and becomes effective, United will execute and deliver a release which will discharge all of the defendants of and from any further liability with reference to any or all of the matters or transactions described or referred to in the various pleadings by the plaintiffs.

ALLOWANCES OF EXPENSES AND ATTORNEYS' FEES

If the Court approves the settlement and orders the entry of judgment dismissing these actions in accordance therewith, petitions will be filed by the above-named attorneys for the plaintiffs in both actions for allowances of fees and expenses which will not exceed the amount of Two Hundred Twenty-five Thousand Dollars ($225,000); and a date will be fixed by the Court, on notice to all who appear at the hearing herein noticed, for considering such petitions. Payment of all such allowances will be made by United out of the benefits and proceeds to be obtained by it as a result of the settlement.

EXAMINATION OF PLEADINGS AND PAPERS IN THE ACTION

The foregoing references to the Stipulation of Settlement, the pleadings and other documents in this action are only summaries thereof. The complete texts are on file with the Clerk of the United States District Court for the Southern District of New York at the United States Courthouse, Foley Square, New York, N. Y. and available for inspection there by any shareholder of United in person or by attorney during regular business hours. Copies of the schedules and documents elicited and produced in the course of discovery proceedings will be available for inspection at the offices of the counsel for the parties hereinabove described by any shareholder of United or their attorney during regular business hours.

Dated: Kansas City, Missouri
December 31, 1969

UNITED FUNDS, INC.

By Rodney O. McWhinney
Secretary

APPENDIX F

Excepts From Horenstein-Ruskay Plaintiffs' Memorandum in Support of Proposed Settlement

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF NEW YORK

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FRED HORENSTEIN and JOSEPH SCIUTO,
Plaintiffs,
-against-
WADDELL & REED, INC., JOE JACK MERRIMAN, CHAUNCEY L. WADDELL, CORNELIUS ROACH, UNITED FUNDS, INC., AND KANSAS CITY SECURITIES CORPORATION,
Defendants.

Action No. 1
67 Civ 4175

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SOPHIE RUSKAY,
Plaintiff,
-against-
JOE JACK MERRIMAN, CHAUNCEY L. WADDELL, CORNELIUS ROACH, CAMERON K. REED, ROBERT W. WAGNER, WADDELL & REED, INC., KANSAS CITY SECURITIES CORPORATION and UNITED FUNDS, INC.,
Defendants.

Action No. 2
69 Civ 276

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MEMORANDUM OF PLAINTIFFS' IN ACTION NO. 1 IN SUPPORT OF THE PROPOSED SETTLEMENT.

Plaintiffs in action no. 1 submit this memorandum in support of the proposed settlement. * * * *

VI. THE CAUSE OF ACTION TO RESTRAIN THE SALE OF W & R SHARES

On June 5, 1969, plaintiffs filed a supplemental complaint, pursuant to the order of Judge Tyler dated May 26, 1969, to enjoin defendants from selling a controlling interest in W & R, or, in the alternative, to impress a trust upon the proceeds of said sale. The action was brought to safeguard the recovery which plaintiffs would receive upon a successful conclusion of this litigation.

The cause of action rested upon the theory that the individual defendants Merriman and Waddell were about to sell a majority of the common stock of W & R to Continental Investment Corp.; that a substantial portion of the value of the W & R shares being sold was attributable to the gains of W & R from the illegal practices alleged in the complaint; that this increment was an asset to United; and that the shareholders of W & R, including defendants Merriman and Waddell, intended to convert this asset to their own use. It was further alleged that in order to protect United and its shareholders and to avoid irreparable harm if the selling shareholders were allowed to dispose of

their W & R stock and do as they pleased with the proceeds, the sale either should be enjoined or the proceeds impressed with a trust.

The issue raised by the supplemental complaint has become moot and is not a factor to be considered by the Court in passing upon the proposed settlement. In June, 1969, the sale was consummated and approved by United shareholders who also approved continuation of the Investment Management Contract. Moreover, there is no longer any need to secure any recovery since the proposed settlement makes adquate provision for payment of the $650,000.

APPENDIX G

Opinion of the District Court Approving the Horenstein-Ruskay Settlement

[¶ 92,678] Horenstein, et al. v. Waddell & Reed, Inc., et al.

United States District Court, Southern District of New York. No. 67 Civ 4175. May 26, 1970. Memorandum opinion in full text.

Investment Advisers—Give-Ups—Reciprocal Arrangements—Churning—Settlement of Action Approved.—The settlement of several derivative suits against the investment adviser of a mutual fund is approved as fair and reasonable in light of the limited chance of the shareholders' success at a trial of the matter and in view of the lack of substance of the objections to the proposed settlement. The evidence appears to be to the effect that the adviser had discharged its obligation conscientiously and in accordance to the contemporary rules of the securities exchanges. Liability for the alleged churning, give-ups and reciprocal arrangements appears to be remote in this case.

See ¶ 22,721 and 22,725, "Exchange Act—Manipulation" division, Volume 2 and ¶ 56,365, "Investment Advisers Act" division, Volume 3.

Bass & Friend (Solomon H. Friend, of Counsel), New York, N. Y. for Plaintiffs Fred Horenstein and Joseph Sciuto.

Joseph A. Ruskay, New York, N. Y. for Plaintiff Sophie Ruskay.

Valicenti, Leighton, Reid & Pine, New York, N. Y. for Defendants Joe Jack Merriman, Chauncey L. Waddell, Cornelius Roach, Robert W. Wagner, Waddell & Reed, Inc. and Kansas City Securities Corporation. (Albert D. Jordan, of Counsel).

Kelley, Drye, Newhall, Maginnes & Warren (Francis S. Bensel, of Counsel), New York, N. Y., Attorneys for Defendant United Funds, Inc.

LASKER, District Judge: This is an application, pursuant to Rule 23 of the Federal Rules of Civil Procedure, for approval of a proposed settlement of two derivative actions, heretofore consolidated, brought by the shareholders of United Funds, Inc. ("United")[1] against Waddell & Reed, Inc., United's investment advisor, manager and underwriter ("W & R"), certain officers and directors of W & R, and Kansas City Securities Corporation ("KCSC"), a wholly owned subsidiary of W & R. Notice of a hearing on the merits of the settlement was mailed to 518,000 shareholders of United in accordance with the order of this court dated December 24, 1969. Five objections to the proposed settlement have been received—two in letter form only. Pursuant to the order of December 24, 1969, a hearing was held on April 6, 1970, at which all present were given an opportunity to be heard and to object to the proposed settlement. Two of the objectants appeared in person. I comment below both on the objections received by letter and those presented at the hearing.

[*Violations Alleged*]

The Horenstein action alleges violations of the Investment Companies Act of 1940, 15 U. S. C. § 80a-1, et seq., the Investment Advisors Act of 1940, 15 U. S. C. § 80b-1, et seq., the Securities Exchange Act of 1934, U. S. C. § 78, et seq., and of defendants' fiduciary obligations under state law. The plaintiffs in the Horenstein action together own about 20,000 shares of United. An amended and a supplemental complaint were filed on June 4, 1968, and June 5, 1969, respectively.

The Horenstein plaintiffs, in September 1968, filed a derivative action on behalf of United in New York Supreme Court, New York County, against the defendants here. The state proceedings have been stayed pending the determination of the case in this court.

The Ruskay action charges matters substantially the same as those described in the Horenstein complaint, but adds the allegation that the defendants have engaged in "churning"—that is, causing an excessive turnover of United's portfolio for the benefit of W & R and KCSC.

The defendants have denied all material allegations of the complaint and asserted a variety of affirmative defenses.

[*Charges*]

The substance of plaintiffs' charges is (1) that the affairs of United and its board of directors were controlled by W & R and the individual defendants; (2) that W & R exploited its power over the execution of United's portfolio transactions by directing the execution of such transactions to its subsidiary KCSC, and other brokers

[1] United is managed open-end investment company usually referred to as a mutual fund.

or dealers who shared their discounts on such transactions through so-called "give-ups" and reciprocal arrangements; (3) that the practices followed have deprived United of the best execution of its portfolio transactions; (4) that such practices have reduced W & R's costs and unjustly increased its management fees; and (5) that the formulae in effect at various times since September 1, 1965 for the reduction of the management fee payable by United to W & R by an amount equal to a portion (currently 50%) of KCSC's net income is illegal to the extent that it permits W & R to benefit from the commissions or discounts paid by United for the execution of its portfolio transactions, and that the approval of such an arrangement by United's shareholders was procured by false or fraudulent proxy statements.

As affirmative defenses, the defendants allege the approval of United's shareholders of the practices complained of, and that the contentions advanced by the plaintiffs in these actions are substantially identical to claims made in an earlier series of stockholder actions on behalf of United which were dismissed on their merits as part of a settlement approved, after hearing on notice to United's shareholders, by order of the Supreme Court of the State of New York, New York County, March 29, 1965.[2]

During the period covered by this suit, W & R has furnished management and investment advisory service to United under the terms of an investment advisory agreement with United which has been approved annually by United's shareholders. Since September 1965, KCSC, a securities broker which is wholly owned by W & R, has handled the execution of United's portfolio transactions. KCSC executes securities transactions for other customers as well. Commencing in September of 1965, the agreement between United and W & R authorized W & R to direct the execution of United's transactions and to direct "give-ups" on such transactions to KCSC and to provide for a reduction of the management fee paid by United to W & R by a sum set in the current contract at 50% of the net income of KCSC (after provision for taxes) from all sources.

Substantial pre-trial discovery has been made by the plaintiffs, including the taking of depositions of defendants Waddell, Merriman and Roach; Jay B. Dillingham and W. Hardy Hendren, unaffiliated directors of United; Don Williams, a Vice President of United and Senior Vice President of W & R in charge of its investment management division; George A. Baker, a Vice President of United and a Vice President of W & R and manager of its trading department; Murray Sweet, an Assistant Vice President of W & R; and Sherman Jones, President of KCSC since October 1968. In addition, as is normal in these cases, plaintiffs' counsel and well qualified accountants, David Berdon & Co., have inspected and reviewed in detail relevant documents, including dealer commission business reports, United's proxies, prospectuses, reports to stockholders, board of directors' minutes, and reports to the SEC; W & R's SEC reports and reports to stockholders; KCSC's income statements, and other material.

Terms of Settlement

The proposed settlement provides for the payment by defendants to United of a total of $650,000 in two parts. $150,000 will be paid to United within thirty days of the effective date of settlement without possibility of any reduction or offsets whatsoever. The remaining $500,000 will be paid in the following manner:

KCSC or W & R will pay to United the additional sum of $500,000 by a payment of $100,000 within thirty days of the effective date of the settlement and payment of a like sum of $100,000 within thirty days of the next succeeding four anniversaries of the said effective date.

[*Tax Treatment*]

Since the settlement agreement provides that the amount of each installment, to the extent paid by KCSC, may be treated as a deduction in the computation of the net income of KCSC for purposes of the formula under which the management fee of United is reduced by a portion of the net income (after taxes) of KCSC (as provided in the investment advisory and management agreement), the ultimate benefit to United of the proposed $500,000 payment may be reduced—at present tax rates—by approximately $23,000 a year,[3]—that is, to a minimum of $385,000, which, added to the $150,-

[2] Defendants also put forth the affirmative defenses of laches and statute of limitations. These defenses have not been presented or discussed in the papers submitted in support of the proposed settlement.

[3] The figure of $23.085 is set forth in the letter of March 26, 1970 from Philip A. Loomis, Jr., General Counsel of the Securities and Exchange Commission, to Judge Palmieri of this court

(*Continued on next page.*)

000 certain, would constitute a net recovery of not less than $535,000.

* * *

The propriety of the proposed settlement should be measured by the likelihood or unlikelihood of plaintiffs' success in the suit and by the quality of the objections made to the settlement. Analysis of the material before me indicates that the likelihood of plaintiffs' success is not great, and that the objections are too weak and insubstantial to preclude approval of the settlement. I treat first the likelihood of plaintiffs' prevailing on the charges they have brought.

1) *Alleged domination of United by W & R and its directors.* The substantial discovery on this point establishes that of the 13 directors on United's board only four were affiliated with W & R. The other nine were active in businesses unrelated to W & R, and their actions as United directors were clearly taken independently of the effect on W & R, and in the best interest of United. Nor has evidence been produced that the W & R affiliated directors used undue influence or violated their fiduciary duties as directors of United. Under the circumstances, it appears that plaintiffs would fail to prove the allegation of dominance of United by W & R and its directors.

2) *Best execution prices.* Although the plaintiffs charge that W & R deliberately put transactions through KCSC on the Pacific Coast Exchange (for KCSC's benefit), even though they could have been arranged on other markets at prices more favorable to United, the evidence fails to meet the allegation. The depositions of Waddell, Merriman and Baker support the proposition that W & R conscientiously discharged its obligation to find the best prices for United's transactions. While it is true that the especially large block of 500,000 shares of Monsanto was sold at 2¼ points below market, discovery established that there were sound business reasons for making such a sacrifice in order to ease United out of its heavy position in a stock which for good reason was believed to be seriously on a downward path.

3) *Third and fourth market transactions.* Although plaintiffs charge that W & R for its own reasons avoided utilization of the third and fourth markets, causing United to incur excess brokerage commissions, the evidence establishes, to the contrary, that the third market was used where appropriate and that the use of the fourth market was impractical in execution of United's transactions.

4) *"Giveups" and reciprocal brokerage.* Although the use of "giveups" (a practice now terminated by Stock Exchange rules but never yet declared illegal or disapproved by the Stock Exchange during the period in which such "give ups" occurred) and reciprocals constituted normal practice within the mutual fund industry over a period of time, plaintiffs nevertheless allege that they were improper in the instant case. At the outset it is important to note that no court decision (nor S. E. C. ruling) has ever outlawed such practices. As stated in *Lessac v. Television-Electronics Fund, Inc.*, CCH Fed. Sec. L. Rep. ¶ 92,305 (S. D. N. Y. 1968),

> ". . . with respect to the cause of action based upon allocations and 'give ups', it should be noted that despite attacks by newspapers and before Congressional Committees and the SEC there has not as yet been any court ruling on the subject and that this area of law is still unsettled. For these reasons, it seems best also that the plaintiffs in the second case settle this cause of action."

The practice of "give ups" arose because, for example, until recently brokerage commissions on the New York Stock Exchange were the same for ten 100-share orders as for one 1000-share order, although it is obvious that the cost to the broker of transacting the single large order would be notably less than in the execution of 10 smaller orders. In order to secure such profitable business on large orders, the broker is often willing to "give up" part of his commission to another broker as directed by the institutional broker. The complainants here charge that W & R directed "give ups" to brokers in return for investment information, or to brokers who sold United shares, or that W & R directed "give ups" to KCSC in the form of cash "give ups" for which no service was ever rendered.

[Reciprocals]

Reciprocals evolve when a broker (here W & R) places its client's (United's) business with another broker on the condition that such other broker reciprocate to the originating broker (as charged here, to KCSC).

(Footnote 3 continued.)
relating to the proposed settlement. The letter specified three possible alternative computations. I am satisfied from my study of the case that the computation which results in the figure of $23,085 is the correct alternative.

Although these practices have been criticized, they have, as stated above, never been held illegal, and furthermore, under the Stock Exchange rules, a broker is forbidden to rebate to its customer any portion of its commissions. Consequently in ordinary circumstances the fund is prevented from reducing its brokerage costs. In view of the apparent permissibility of such practices (prior to the time they were discontinued by Stock Exchange ruling), it is highly doubtful whether this portion of plaintiffs' complaints could be sustained. But there are other reasons why plaintiffs would be unlikely to prevail here as to the "give ups" and reciprocals:

a) By the terms of the W & R-United agreement, a portion of the commisisons (50%) generated by the United portfolio brokerage transactions is credited towards the payment of United's fee to W & R.

b) The settlement here is in an amount substantially in excess of the value of the "give ups" that have not been credited to United's fee obligations.[4]

c) Discovery in this case has demonstrated that in all instances save one (cash "give ups") commissions earned by brokers from the direction of "give ups" or reciprocal business required the receiving brokers to perform services.

For these reasons it is clearly unlikely that the plaintiffs would succeed on this branch of their suits. An additional reason for approval of the proposed settlement insofar as "give ups" are concerned is that the settlement will assure United's recovery of the remaining portion of net profits, after provision for income taxes, attributable to cash "give ups" received by KCSC from its inception in 1965 to December 5, 1968, the date when "give ups" were abolished by the Stock Exchange.

5) *Alleged violation by W & R of the stipulation of settlement of the prior stockholder suits.* It is claimed that defendants' practices violate a judgment and order entered in the New York Supreme Court, New York County, March 29, 1965, in settlement of several prior derivative actions which attacked as excessive W & R's management fees. The stipulation of settlement there provided that W & R should neither seek nor accept any increase in the "rate of compensation" over and above the rates provided in a proposed investment management agreement. Plaintiffs claim that the receipt by W & R of net profits retained by KCSC arising from United transactions constituted an increase in W & R's rate of compensation. There are substantial obstacles to the plaintiffs' succeeding in proving this cause of action:

a) The discovery clearly indicates that KCSC was organized for the primary purpose of recapturing for United shareholders a portion of the brokerage commissions attributable to United's transactions.

b) United's shareholders ratified the terms of settlement of the earlier litigation. Thereafter, having been kept fully informed of the organization of KCSC and of the terms of the proposed W & R-United agreement, United's shareholders approved the first W & R-United agreement and annually reapproved and ratified renewals thereof. Such approval and reapprovals were supported by an overwhelming majority of the shareholders, who voted in person or by proxy. Furthermore, no evidence or argument has been offered in the material before me to establish that there is any support for the allegation that such stockholder approval was procured by false proxy statements; indeed, there seems to be no basis for that charge.

c) There are, at the least, serious questions as to whether W & R's receipt of a portion of KCSC's commissions constituted an increase in W & R's "rate of compensation" within the meaning of the settlement stipulation in the earlier litigation.

6) *The "churning" charge.* In spite of the voluminous documents inspected and studied both by counsel and accountants, and the depositions taken, no evidence has been forthcoming to support the charge of churning. Although proof of such a charge is at best difficult, in view of the numerous justifiable reasons for which sales and purchases are made, nevertheless here the proof is utterly deficient. The difficulty of proving churning in any event is probably the reason why, as stated in the Horenstein plaintiffs' memorandum, "[c]ounsel have been unable to find a single case supporting the proposition that the turnover rate of transactions in portfolio securities of a mutual fund constitutes an actionable wrong and gives rise to a cause of action." Certainly in theory the deliberate engage-

[4] Fifty percent (50%) of the "giveups" has previously been credited to United from profits realized by KCSC. The remaining 50% is computed to amount to approximately $283,780.27 (see Memorandum of Plaintiffs in Action No. 1 in Suport of the Proposed Settlement, p. 14). This computation has not been contested.

ment by an investment advisor in "churning," which, almost by definition, would be inimical to the interests of the managed fund, may be actionable. But here the evidence is lacking to support the charge.

[*Objections*]

Having discussed the possibilities of plaintiffs success in the instant case, I turn to the five objections presented by letter or in person at the hearing.

1) The objection of William W. George (presented by letter only) is restricted to requesting the court to "consider the consequences of permitting a mutual fund manager to enter a plea of laches for any offense and not be concerned about the details of the case before you." In view of the fact that the defense of laches has not been presented by any of the parties as a basis for the approval of settlement and that the "details of the case" have been considered in depth, the objection is dismissed as unmeritorious.

2) The letter objection of E. W. Kelley, Custodian for Karen Kay Kelley (owner of 983.198 shares), includes no attack on the merit of the settlement, but merely requests that the writer be advised of the time and place of the hearing on proposed attorneys' fees. He will be so advised.

3) The letter objection of T. H. Willcox, Jr., an attorney, on behalf of his minor children's fund in the name of their mother as Custodian, states: "I know nothing of the merits of the cause, but would hazard a guess that the claims are largely without merit." He clearly does not object to the terms of the settlement, but does request an opportunity to challenge the proposed attorneys' fees and will be granted that right.

4) The objection of Heizer Wright, as Trustee for Frances Wright, was made by letter and in person at the hearing. Mr. Wright sets forth several complaints:

a) That the notice of settlement hearing does not indicate the amount sought in the complaints and that is therefore impossible to determine whether the settlement is a fair one.

[*Damages Unspecified*]

It is true that the notice of settlement did not (and it is not uncommon that notices of settlement do not) set forth the amount sought in the complaints. An examination of the complaints here indicates that with one exception the damages sought were unspecified and unliquidated—apparently being unknown to plaintiffs. The one exception is the Second Verified Amended Complaint in the Horenstein action (p. 29, ¶ G), praying damages "in the amount of $2,064,000, plus such additional damages after August 31, 1967, which United has suffered." While even this complaint leaves unclear the precise amount sought by plaintiffs, it is evident that even the minimum amount proposed of $535,000 (much less the possible maximum of $650,000) would constitute a respectable settlement in relation to the $2,064,000 figure named (considering plaintiffs' difficulties in this case); and even were the ultimate damage to be shown, for example, double the $2,064,000 specified, I find that the proposed settlement would be fair and reasonable.

b) That W & R and KCSC are not prohibited by the settlement from further dealings with United.

Here it suffices to say that the W & R-United agreement runs for only a year at a time and must be and has been regularly ratified and approved by the shareholders of United, who are free to discontinue it at the end of any annual period. It seems evident that by their constant approval and reapproval of the agreement in the past, the United shareholders have found it beneficial to them; but in any event, since they are free to discontinue it in relatively short order, there is no need to include in the settlement agreement the prohibition suggested by the objectant, nor indeed has anyone except this objectant suggested that the W & R-United agreement should be discontinued.

c) That "the matters set forth in the Notice of Settlement Hearing suggest criminal liability as well as civil liability" and that "there should be notice to, and investigation by, the Securities Exchange Commission."

The short answer to these contentions is that matters of criminal liability are the responsibility of the Executive branch of the government and that the S. E. C. has been fully informed of the terms of the proposed settlement (having had before it, on the orders of this court, all the material submitted to the court) and has presented no objection to the settlement.

d) That the notice of settlement hearing is insufficient because sent by "junk mail."

[*Notice Mailed*]

In answer to this contention, it is sufficient to state that the notice of hearing was mailed in accordance with the approval and order of this court.

5) The final and most serious objection is raised by Joan B. Sanger, holder of 4,255.341 shares of United Accumulative Fund.• The burden of the Sanger objection (which was brought to the attention of the office of the General Counsel of the Securities and Exchange Commission by a letter from the objectant's attorney under date of April 16, 1970) is that the notice of settlement hearing was deficient in that under the title "Summary of Settlement Terms" the possible reduction of the settlement sum (from $650,000 to $535,000) is indicated by formula only, and not in specific figures. Though there can be no argument that a statement in the notice of the minimum amount recoverable in dollar figures would have been preferable to the formula description, nevertheless this does not render the notice fatally inadequate because (i) the notice as phrased is clear warning that the amount recoverable might be reduced in accordance with the formula; (ii) the formula was understandable to stockholders who had in the past (a) litigated the W & R-KCSC-United arrangement and (b) from 1965 through 1969 overwhelmingly approved the terms of the W & R-KSCS-United agreement which had been set forth in voluminous detail in each year's proxy material. The court is satisfied that, in the context of the history of this and the prior litigation, and particularly in view of the annual review of the W & R-United agreement in precise terms, the notice of settlement hearing adequately advised the shareholders of United of the method of determining the effect of the possible reduction and of the possibility that the ultimate amount received by United could well be reduced below $650,000. Perhaps the best evidence of the adequacy of the notice is the fact that Joan Sanger herself, on receipt of the notice, objected to the possibility of reduction which she clearly noted as set forth in the terms of settlement.•

[*Settlement Approved*]

On the basis of the analysis above, the court is satisfied that, because of the limited chances of plaintiffs' success in this litigation and the lack of merit of the objections, the proposed settlement is fair and equitable and should be approved. Beyond these arguments, it is to be noted that on a motion to review a proposed settlement agreement "the role of the Court is limited to the extent that its business judgment is not to be substituted for that of the parties who worked out the settlement, and . . . the only question before us is whether the settlement, taken as a whole, is so unfair on its face as to preclude judicial approval." *Glicken v. Bradford*, 35 F. R. D. 144, 151 (S. D. N. Y. 1964, opinion of Chief Judge Ryan). As recently stated by Judge Wyatt in *Josephson v. Campbell*, CCH Fed. Sec. L. Rep. ¶ 92,347 at p. 97,658 (S. D. N .Y., Jan. 24, 1969):

> "There is a strong initial presumption that the compromise is fair and reasonable. This rests on a number of factors. Counsel for plaintiffs is able and experienced, particularly in the specific area with which these actions are concerned. His judgment is entitled to great weight . . ."

Upon all the facts and circumstances presented, I find the proposed settlement agreement to be fair and reasonable and in the best interests of all concerned, and it is therefore approved.

Settle judgment and order on notice.

• United is constituted of several different separate funds, each with different investor objectives, of which United Accumulative Fund is one.

• It should be noted that it is not certain that a reduction will in fact occur. The actuality of a reduction will depend on the existence of all three of the following contingencies:

(1) That the W & R-United agreement is still in effect at the time of the particular payment from which a reduction might be made;

(2) That payment is made by KCSC rather than by W & R;

(3) That payment is treated as a deduction in the computation of KCSC's taxable income. It is to be further noted that, in accordance with the instructions of the court, copies of all papers before me on this motion were forwarded to the Securities and Exchange Commission. In its letter of March 26, 1970 to Judge Palmieri (see Footnote 3 above) the Commission did not raise objections to the proposed settlement, though it did observe that the effect of the settlement might be to reduce the maximum payment of $650,000 by $23,085 a year, as indicated in Footnote 3. By letter of April 21, 1970, after examination of the papers on this motion, the General Counsel of the S. E. C. wrote as follows:

"Dear Judge Lasker:

"This refers to the letter of your clerk, A. Howard Matz, of April 15, requesting our views about the adequacy of the notice of the settlement in the above entitled actions. After reviewing the material we have no further comments on the notice of settlement."